CPA REVIEW TEXTBOOK

SURGENT CPAreview

REG

Taxation and Regulation

SECTIONS 4000–4500

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Surgent CPA Review:
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Surgent CPA Review was developed by a team of professionals who are experts in the fields of accounting, business law, and computer science, and are also experienced teachers in CPA Review programs and continuing professional education courses.

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We recognize the work and dedication of our team of software designers and developers. Their vision has made this the best product possible. They contributed countless hours to deliver this package and are each fully dedicated to helping you pass the exam. Our thanks go out to the many individuals who have made contributions to both the software and textbook portions of the CPA Review. We extend our gratitude to our team of software testers who ensure that you receive only the highest quality product. Finally, we express appreciation to the editorial teams who have devoted their time to review this product. They have provided invaluable aid in the writing and production of the Surgent CPA Review.

Good luck on the exam!

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Section 4000
Overview of the Taxation and Regulation Core

4010 The CPA Examination

4010.01 The Exam

The Uniform CPA Examination (the Exam) provides reasonable assurance to state boards of accountancy that individuals who pass the Exam possess the minimum level of technical knowledge and skills necessary for initial licensure. Ongoing changes in the business world, along with advancements in technology, have impacted the accounting profession and affected the required knowledge, skills, and professional responsibilities of newly licensed Certified Public Accountants (CPAs).

To remain relevant to the real-world demands of the profession, the AICPA has determined that newly licensed CPAs must not only demonstrate sufficient content knowledge, but also possess:

a. higher-order cognitive skills, including critical thinking, problem solving, and analytical ability, as well as professional skepticism,

b. a thorough understanding of professional and ethical responsibilities,

c. a strong understanding of the business environment and processes, and

d. effective communication skills.

4010.02 AICPA Skill Framework

The AICPA has adopted a skill framework based on the modified Bloom's Taxonomy of Educational Objectives. Bloom's Taxonomy classifies a continuum of skills that students can be expected to learn and demonstrate. The taxonomy is widely used in educational and licensure testing to define the level of skills to be assessed and to guide the development of test questions.

In applying this framework, representative tasks that a newly licensed CPA may be expected to complete were identified. Based on the nature of a task, one of four skill levels is assigned to each of the tasks, as follows:

Skill Levels	
Evaluation	The examination or assessment of problems, and use of judgment to draw conclusions.
Analysis	The examination and study of the interrelationships of separate areas in order to identify causes and find evidence to support inferences.
Application	The use or demonstration of knowledge, concepts, or techniques.
Remembering and Understanding	The perception and comprehension of the significance of an area utilizing knowledge gained.

4010.03 Exam Focus

The percentage for each skill level for each exam section is shown in the table below:

Section	Remembering and Understanding	Application	Analysis	Evaluation
AUD – Core	30%–40%	30%–40%	15%–25%	5%–15%
FAR – Core	5%–15%	45%–55%	35%–45%	-
REG – Core	25%–35%	35%–45%	25%–35%	-
BAR – Discipline	10%–20%	45%–55%	30%–40%	-
ISC – Discipline	55%–65%	20%–30%	10%–20%	-
TCP – Discipline	5%–15%	55%–65%	25%–35%	-

4010.04 Content Integration

As discussed previously, each of the Exam sections is designed to test higher-order skills by incorporating the applicable content knowledge and skills that are required in the context of the work of a newly licensed CPA. Tasks that involve application, analysis, and/or evaluation skills may include some content from other Exam sections, which would occur naturally in the task from a contextual perspective. These tasks will always be based upon the primary content knowledge of a particular Exam section, but could draw upon a candidate's basic knowledge of general accounting, auditing, tax, and business concepts. For example, in the AUD section of the Exam, a TBS designed to evaluate inventory observation audit procedures might include some inventory valuation/obsolescence or sales cutoff considerations, even though these concepts would be evaluated more extensively in FAR.

4010.05 Blueprint

The Blueprint is organized by content AREA, content GROUP, and content TOPIC. Each topic includes one or more representative TASKS. The purpose of the Blueprint is to:

a. document the minimum level of knowledge and skills necessary for initial licensure.

b. assist candidates in preparing for the Exam by outlining the knowledge and skills that may be tested.

c. apprise educators of the knowledge and skills candidates need to function as newly licensed CPAs.

d. guide the development of Exam questions.

The tasks in the Blueprint are representative; they are not intended to be viewed as an all-inclusive list of tasks that may be tested. It is important to note that the number of tasks associated with a particular content group or topic is not indicative of the extent such content group, topic, or related skill level will be assessed on the Exam.

4010.06 Exam Testing Time

Total Exam time is 16 hours—four sections of 4 hours each. Candidates must complete the information on the welcome screen within 5 minutes and must accept the policy statement and confidentiality policy screens within 5 minutes. If these screens are not completed within this time frame, the exam will shut down and will not be restarted.

Each of the exam sections consists of a series of five testlets. Each testlet contains either (but not both) multiple-choice questions (MCQs) or task-based simulations (TBSs).

A 15-minute standardized break is given after the first TBS testlet, at approximately the 2-hour point. The Exam clock pauses for this break only; you can choose to decline the standardized break and continue testing, but the break will not be offered again. If you choose to take the standardized break, you must leave the testing room, adhering to all security protocols, and you will be readmitted to the testing room once cleared by Prometric personnel. If you have not returned and started the fourth TBS testlet prior to the expiration of 15 minutes, the Exam clock will restart. You will be asked to re-enter your launch code to restart the exam.

Candidates may choose to take an optional break between any two testlets, but it will count against total testing time as the Exam clock continues to run.

4010.07 Testlet Organization

Section	Question Type	Weighting
AUD Core	78 MCQs 7 TBSs	50% 50%
FAR Core	50 MCQs 7 TBSs	50% 50%
REG Core	72 MCQs 8 TBSs	50% 50%
BAR Discipline	50 MCQs 7 TBSs	50% 50%
ISC Discipline	82 MCQs 6 TBSs	60% 40%
TCP Discipline	68 MCQs 7 TBSs	50% 50%

4020 The Taxation and Regulation Section of the CPA Examination

4020.01 The Taxation and Regulation (REG) section tests a candidate's knowledge and skills required of newly licensed CPAs with respect to ethics and professional responsibilities related to tax practice, business law, and federal tax compliance for individuals and entities with a focus on recurring and routine transactions. The tasks listed in the Blueprint are representative only; they are not intended to be an all-inclusive listing.

4020.02 **Section Content**

REG content areas and allocation of content to be tested are presented in the following table:

I. Ethics, Professional Responsibilities, and Federal Tax Procedures	10%–20%
II. Business Law	15%–25%
III. Federal Taxation of Property Transactions	5%–15%
IV. Federal Taxation of Individuals	22%–32%
V. Federal Taxation of Entities (Including Tax Preparation)	23%–33%

4020.03 **REG Skill Allocation**

Each representative task in the REG section blueprint is assigned a skill level. The REG section does not test any content at the Evaluation skill level as newly licensed CPAs are not expected to demonstrate that level of skill in regard to REG content. REG section considerations related to the skill levels are as follows:

1. **Remembering and Understanding** is primarily tested in Areas I and II. The content in these two areas is tested at the lower end of the skill-level continuum.
2. **Application** and **Analysis** skills are concentrated in Areas III, IV, and V. These areas contain more of the day-to-day tasks that newly licensed CPAs are expected to perform, and are therefore tested at the higher end of the skill-level continuum.

4020.04 References for the Taxation and Regulation section include the following:

1. Revised Model Business Corporation Act
2. Revised Uniform Limited Partnership Act
3. Revised Uniform Partnership Act
4. Uniform Accountancy Act
5. Uniform Commercial Code
6. Internal Revenue Code of 1986, as amended
7. Treasury Department Circular 230, *Regulations Governing Practice Before the Internal Revenue Service*
8. Treasury Regulations
9. Other administrative pronouncements regarding federal taxation
10. Case law on federal taxation
11. Public Law 86-272
12. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

13. Patient Protection and Affordable Care Act
14. Foreign Corrupt Practices Act of 1977
15. Uniform Division of Income for Tax Purposes Act (UDITPA)
16. Current textbooks covering business law, federal taxation, accounting, and ethics

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Section 4100
Ethics, Professional Responsibilities, and Federal Tax Procedures (10% - 20%)

4110 Ethics and Responsibilities in Tax Practice

4111 Regulations Governing Practice Before the Internal Revenue Service

4111.01 The Secretary of the Treasury has the power to prescribe rules and regulations regarding the conduct of tax practitioners who represent taxpayers before the IRS. These rules are in Title 31 of the Code of Federal Regulations and are commonly referred to as "Circular 230."

4111.02 The Secretary of the Treasury also has the power to appoint a director of practice under Circular 230. The director's duties include:

- **a.** acting upon applications for enrollment to practice before the IRS,
- **b.** instituting and conducting disciplinary hearings,
- **c.** making inquiries as to matters under their jurisdiction, and
- **d.** other duties that are necessary to carry out their functions.

Practice Before the IRS

4111.03 Practice before the IRS is defined in Circular 230 as involving all matters connected with a presentation to the IRS, or any of its officers or employees, relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. This includes:

- **a.** preparing and filing documents,
- **b.** corresponding and communicating with the IRS,
- **c.** rendering written advice with respect to any entity, transaction, plan, or arrangement, and
- **d.** representing a client at conferences, hearings, and meetings.

4111.04 Certified public accountants (CPAs) and attorneys may practice before the IRS provided they are not under suspension or disbarment from practice before the IRS. A CPA is any person duly qualified to practice as a CPA in any state, possession, territory, commonwealth, or the District of Columbia. An attorney is a person who is a member in good standing of the bar of the highest court of any state, possession, territory, commonwealth, or the District of Columbia. CPAs and attorneys must file a written declaration that they are currently qualified as a CPA or attorney and that they are authorized to represent the taxpayer in question.

4111.05 Individuals may also practice before the IRS if they qualify as an enrolled agent. An application for enrollment must be filed with the Director of Practice. The applicant must then demonstrate competence in tax matters by passing a written examination.

4111.06 An individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries may also practice before the IRS. Practice by an enrolled actuary is limited by Circular 230 to issues concerning pension and employee benefit plans.

4111.07 An individual may also practice before the IRS as an enrolled retirement plan agent (practice is limited to certain issues and programs involving retirement plans). Enrollment as a retirement plan agent is granted after the individual passes a written examination that demonstrates special competence in qualified retirement plan matters.

4111.08 Former IRS employees may be granted enrollment as an enrolled agent or enrolled retirement plan agent by virtue of their past service and technical experience gained as an IRS employee.

4111.09 Circular 230 allows individuals who are not CPAs, attorneys, or enrolled agents to engage in limited practice before the IRS. As a result, an individual can represent themselves before the IRS provided they present satisfactory identification.

Limited Practice Before the Internal Revenue Service

4111.10 An individual may also engage in limited practice before the IRS even if the taxpayer is not present, in the following situations:

- **a.** An individual may represent a member of their immediate family.
- **b.** A regular, full-time employee of an individual employer may represent the employer.
- **c.** A general partner or a regular full-time employee of a partnership may represent the partnership.
- **d.** A bona fide officer or regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.
- **e.** A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust.
- **f.** An officer or a regular employee of a government unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.
- **g.** An individual may represent any individual or entity who is outside the United States, when the representation takes place outside the United States.
- **h.** An individual who signs the taxpayer's return as the preparer (or who prepares a return but is not required to sign the tax return) may represent the taxpayer before IRS employees of the examination division regarding the tax liability of the taxpayer for the period covered by the return.

Practitioner Duties and Restrictions

4111.11 A practitioner has a duty to promptly submit records or information to the IRS upon proper request. Also, there is a duty not to interfere with any lawful effort of the IRS to obtain such records or information. These duties exist unless the practitioner in good faith and on reasonable grounds believes the record or information is privileged.

4111.12 A practitioner has a duty to provide the director of practice with any requested information regarding violations of any regulations dealing with practice before the IRS.

4111.13 A practitioner who knows that a client has not complied with the revenue laws of the United States, or has made an error in or omission from any return, document, affidavit, or other paper, has a duty to advise the client promptly of such noncompliance, error, or omission.

4111.14 A practitioner must exercise due diligence in the following situations:

- **a.** In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to IRS matters

b. In determining the correctness of oral or written representation made by the practitioner to the Department of the Treasury

c. In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS

A practitioner will be presumed to have exercised due diligence if the practitioner relies on the work product of another person.

4111.15 A practitioner may not unreasonably delay prompt disposition of any matter before the IRS.

4111.16 A practitioner may not knowingly and directly or indirectly accept assistance from or assist any person who is under disbarment or suspension from practice before the IRS. The practitioner must also not accept assistance from any former government employee disqualified from practice under any rule or U.S. law.

4111.17 A practitioner may not act as a notary public with respect to any matter administered by the IRS for which the practitioner is employed as counsel, attorney, or agent, or in which the practitioner may in any way be interested.

4111.18 A practitioner may not charge an unconscionable fee in connection with any matter before the IRS.

4111.19 A practitioner generally may not charge a contingent fee for services rendered in connection with any matter before the IRS. However, a practitioner may charge a contingent fee for services rendered in connection with the IRS's examination of or challenge to:

a. an original return or

b. an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of or a written challenge to the original return.

A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS. A practitioner can charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

4111.20 In general, a practitioner must, at the request of the client, promptly return any and all records of the client that are necessary for the client to comply with his or her federal tax obligations. The practitioner may retain copies of the records returned to a client (Circular 230, Section 10.28).

4111.21 Generally, a practitioner is not allowed to represent conflicting interests in his or her practice before the IRS. However, the practitioner may represent conflicting interests provided the representation is not prohibited by law, and each affected client waives the conflict of interest by informed, written consent.

a. The AICPA *Code of Professional Conduct* and Treasury Circular 230 both address conflicts of interest, but also have key differences.

	AICPA *Code of Professional Conduct*	Treasury Circular 230
Client Relationships	Addresses conflicts arising from client relationships with other members of the same firm	No reference to client relationships with other members of the same firm
Waiver of Conflicts	Does not need to be in writing	Must be in writing
Perception of Others	Perception of others about independence matters	No reference to perception of others

b. Practitioners providing tax services must consider both the AICPA *Code of Professional Conduct* and Treasury Circular 230 when determining whether a conflict of interest exists.

c. Member firms must have a procedure in place to determine whether a conflict of interest exists. Such procedure must be appropriate for the size of the firm and type of practice. Per Circular 230 guidelines, the firm's tax leaders are responsible to ensure all firm members comply with such procedures.

4111.22 Practitioners are subject to various duties and restrictions regarding advertising and solicitation. For example, a practitioner may not use any form of public communication that contains any statement or claim that is false, fraudulent, unduly influencing, coercive, unfair, misleading, or deceptive. Also, a practitioner may not make any uninvited written or oral solicitation of employment in matters before the IRS if the solicitation violates federal or state law or other applicable rule.

4111.23 A practitioner who prepares tax returns may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a federal tax liability.

4111.24 A practitioner may not advise a client to take a position on a document, affidavit, or other paper submitted to the IRS unless the position is not frivolous.

4111.25 A practitioner may not advise a client to submit a document, affidavit, or other paper to the IRS:

a. the purpose of which is to delay or impede the administration of the federal tax law,

b. that is frivolous, or

c. that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation, unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

4111.26 A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to a position taken on a tax return if the practitioner advised the client with respect to the position or the practitioner prepared or signed the return. Also, a practitioner must inform the client of any penalties reasonably likely to apply regarding any document, affidavit, or other paper submitted to the IRS. A practitioner must inform the client of the opportunity to avoid any penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

4111.27 A practitioner can generally rely on information furnished by a client without verification. However, a practitioner cannot ignore information which is actually known and must make reasonable inquiries if the information furnished by the client appears incorrect, inconsistent, or incomplete.

4111.28 A practitioner may give written advice (including electronic communication) concerning federal tax issues only if the practitioner:

- **a.** bases the written advice on reasonable factual or legal assumptions (including assumptions as to future events),
- **b.** reasonably considers all relevant facts and circumstances that the practitioner knows or has reason to know,
- **c.** uses reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter,
- **d.** does *not* rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable,
- **e.** relates applicable law and authorities to facts, or
- **f.** does *not,* in evaluating federal tax matters, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

Email communication with clients on simple matters will not be held to the rigorous standards set out above.

Example: J, a practitioner, fails to note that there is a split among the circuit courts on the subject matter of his legal advice. This is a violation of *e.* above.

Sanctions for Violation of the Regulations

4111.29 The Secretary of the Treasury, after notice and an opportunity for a proceeding, may censure (a public reprimand), suspend, or disbar any practitioner from practice before the IRS if the practitioner:

- **a.** is shown to be incompetent, or disreputable,
- **b.** refuses to comply with any rules in Circular 230, or
- **c.** with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

4111.30 Incompetence and disreputable conduct for which a practitioner may be sanctioned includes, but is not limited to, the following:

- **a.** Conviction of any criminal offense under the federal tax laws
- **b.** Conviction of any criminal offense involving dishonesty or breach of trust
- **c.** Conviction of any felony under federal or state law for which the conduct involved renders the practitioner unfit to practice before the IRS
- **d.** Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, federal tax

returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."

e. Solicitation of employment as prohibited under Circular 230, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the IRS or any officer or employee thereof

f. Willfully failing to make a federal tax return in violation of the federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any federal tax

g. Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade federal taxes or payment thereof

h. Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States

i. Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the IRS by the use of threats, false accusations, duress, or coercion; by the offer of any special inducement or promise of an advantage; or by the bestowing of any gift, favor, or thing of value

j. Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any state, territory, or possession of the United States, including a commonwealth, or the District of Columbia, any federal court of record or any federal agency, body, or board

k. Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility of such other person

l. Contemptuous conduct in connection with practice before the IRS, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter

m. Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the federal tax laws

n. Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by federal tax laws unless the failure is due to reasonable cause and not due to willful neglect

o. Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a disciplinary proceeding

4111.31 A practitioner may also be disbarred or suspended from practice for:

a. willfully violating the regulations in Circular 230 or

b. through recklessness or gross incompetence, violating the standards in Circular 230 with respect to tax returns, documents, affidavits, and other written advice.

4111.32 Rules applicable to disciplinary proceedings

a. Circular 230 contains detailed rules regarding the process to be followed in disciplinary hearings regarding a practitioner's violation of any of the rules.

b. Proceedings are held before an administrative law judge following procedures specified in Circular 230. The judge files his or her decision with the Director of Practice.

c. An appeal of the decision of the administrative law judge can be made to the Secretary of the Treasury within 30 days of the decision.

d. If a practitioner is suspended as a result of the proceedings, they are prohibited from practicing before the IRS during the period of the suspension.

e. If a practitioner is disbarred, the practitioner is not allowed to practice before the IRS until authorized to do so by the Director of Practice. A practitioner who is disbarred may petition for reinstatement after five years from the date of disbarment. Reinstatement is only granted if the Director of Practice believes that the petitioner is not likely to conduct themselves in violation of the rules and that granting reinstatement is not contrary to public policy.

4112 Internal Revenue Code and Regulations Related to Tax Return Preparers

4112.01 A compensated tax return preparer can be liable for civil and criminal penalties for negligently or intentionally understating a taxpayer's liability.

4112.02 A compensated preparer can be liable for the greater of $1,000 or a 50% penalty of income derived (first-tier penalty) for each tax return or claim for refund that understates the taxpayer's liability due to unreasonable positions. There is a second-tier penalty of $5,000 or 75% penalty of income derived if the preparer willfully or recklessly understated the liability. This penalty applies if the preparer did the following:

a. Understated tax liability by taking a position that does not have a realistic possibility of being sustained

b. Knew or should have known of this position

c. Did not disclose the position in the return or an attachment to the return

4112.03 The following are some of the compensated tax return preparer's requirements under the Internal Revenue Code; under Title 26, failure to comply can result in a penalty of $50 for each failure, with a maximum penalty imposed on any tax return preparer not to exceed $27,000 (for calendar year 2022) in a return period:

a. Sign the return, and give the address and IRS identification number of self or employer.

b. Furnish the taxpayer a copy of the prepared return no later than the time the original return is presented for signing.

Example: J, a return preparer, fails to send copies to all clients. J will be penalized $50 for each client, up to $27,000 total for a calendar year.

c. Maintain a file of returns and log of all returns prepared for three years following the close of the return period. The penalty assessed for failure to comply with the requirements of sections *a.–b.* is $50 per occurrence. The penalty will not apply if the failure is due to reasonable cause and not to willful neglect.

d. Do not cash another person's tax refund check. A penalty of $545 is assessable against a preparer who violates this provision.

4112.04 Criminal penalties can be imposed for the following:

- **a.** Tax evasion
- **b.** Perjury on a tax return
- **c.** Bribery of an IRS employee

4120 Licensing and Disciplinary Systems

4120.01 The professional ethics division of the AICPA interprets the *Code of Professional Conduct,* investigates potential disciplinary matters involving members, and presents cases before the AICPA joint trial board (this board judges disciplinary charges against state CPA society and AICPA members).

4120.02 The AICPA professional ethics division's activities are performed within the joint ethics enforcement program (JEEP), in which 48 state CPA societies participate. Generally, the codes of conduct of these societies conform to the AICPA Code.

4120.03 The AICPA and state societies act as agents of each other in ethics investigations. They present cases before the joint trial board according to the bylaws of each organization. For example, if the AICPA conducts an ethics investigation of a member, it does so on its own behalf and also on behalf of the state society of which the individual is a member. The same idea applies in reverse if a state society is conducting the investigation.

4120.04 Bylaws provide for the jurisdiction of the joint trial board over the membership of both the AICPA and the state societies.

4120.05 The AICPA professional ethics division is authorized to start an investigation based on information from various sources. This information of a potential disciplinary matter can come from such sources as written complaints, reports in the media, or referrals from government agencies.

4120.06 The AICPA professional ethics division works through several committees:

- **a.** The professional ethics executive committee
- **b.** The technical standards subcommittee (an investigative body)
- **c.** The government technical standards subcommittee (which investigates engagements in which the clients are state or local government entities or receive federal financial assistance)
- **d.** The independence-behavioral standards subcommittee (which investigates and interprets the Code's rules on independence, confidentiality of client information, and other behavioral concerns)

4120.07 The AICPA professional ethics division has the authority to settle cases brought before it. This enables the division to conclude investigations without the delay or expense of formal hearings.

4120.08 **CPE requirements:** State boards of accountancy are generally in charge of maintaining records of continuing education of all CPAs licensed in that state. The CPA must attest to the state board that the continuing education requirements have been completed. Most jurisdictions run random audits of the CPA records to determine if the reporting of continuing education was both accurate and timely.

4120.09 **Requirements for a CPA license:** Most states have specific requirements for the college credit hours that must be completed in auditing and accounting courses by a candidate for a CPA license. Candidates with deficiencies must complete college credit courses to fulfill the requirements for a CPA license.

4120.10 Reciprocity is a recognition of licenses between states. Therefore, before a certified public accountant moves to another state, he/she must look into the reciprocity rules in the new state. The ability to transfer licensing credentials from one state to another is controlled by state boards and reciprocity is not guaranteed.

4120.11 The NASBA (National Association of State Boards of Accountancy) is the regulating department for the state boards. The NASBA Tools for Accounting Compliance give the candidate much information to inform him/her of the requirements for multiple jurisdictions.

4120.12 In the United States, licensing of certified public accountants is the responsibility of state boards of accountancy. There are 54 jurisdictions that license CPAs, including the 50 states, the District of Columbia (Washington, D.C.), Puerto Rico, Guam, and the U.S. Virgin Islands. Each board of accountancy operates under the AICPA and National Association of State Boards of Accountancy (NASBA) Uniform Accountancy Act (UAA), which establishes the board and sets the requirements for licensing for certified public accountants. The state laws are generally modeled on the UAA.

4120.13 To qualify for a CPA license in any of the 54 jurisdictions, a candidate must successfully complete the Uniform CPA Examination. Every state uses the examination prepared by the AICPA. The scores are sent to the state where the candidate has registered, but the scores can then be transferred from the test state to any other state.

4120.14 State boards of accountancy all use scores from the Uniform CPA Examination to qualify candidates for certification and licenses to practice. Each state board establishes its own rules on residency, citizenship, education, and experience, and some require the completion of an ethics examination to qualify for a CPA license. After licensing, state boards have established requirements for continuing professional education (CPE). State boards establish the rules to qualify for a license and also the rules for revoking a license.

4130 Federal Tax Procedures

4131 Audits, Appeals, and the Judicial Process

4131.01 **Preliminary review**

a. The IRS Service Center where the return is filed conducts a routine review of the return for obvious errors such as:

(1) a failure to sign the return,

(2) a failure to report an item from an information return on the tax return, or

(3) a mathematical error or clerical error, such as the use of an incorrect table.

- **b.** The taxpayer is then mailed a corrected tax calculation and, if there is a deficiency, a request to pay the additional amount.
- **c.** If the taxpayer fails to respond, the IRS generally conducts either a correspondence or an office audit.
- **d.** This review process is not considered a formal examination of the return. Therefore, the taxpayer is not entitled to the administrative remedies available for formal examinations.

4131.02 Selection of returns for audit

- **a.** The IRS uses a method called the Discriminant Function System (DIF), which uses mathematical formulas in order to select returns that are most likely to contain errors and to generate the most additional revenue on audit. The formulas used are developed from information gained in regular audits and audits of randomly selected returns. The randomly selected returns are chosen under the National Research Program (NRP).
- **b.** Specific factors used by the IRS in determining which returns are selected for audit are not disclosed by the IRS.
- **c.** In addition to the computerized selection process, returns can be selected for audit under a number of other methods. For example, returns can be selected for audit:
  - (1) due to information obtained as a result of information exchange programs with state or foreign agencies,
  - (2) due to information obtained from an informant,
  - (3) because the return is linked in some way to another return already being audited, or
  - (4) because the taxpayer’s taxable income, total assets, gross receipts, or deductions exceed certain thresholds established by the IRS.

4131.03 Types of examinations: Correspondence examinations

- **a.** If only a few items are in question on the taxpayer’s return, an examination may be conducted through correspondence with the taxpayer.
- **b.** The examiner will contact the taxpayer by letter and ask that the questionable items on the return be verified by appropriate documentation.
- **c.** A taxpayer involved in a correspondence examination has the same appeal rights as a taxpayer involved in an office or field examination.
- **d.** If the issues cannot be resolved, the case will be referred for handling as either an office or field examination.

4131.04 Types of examinations: Office examinations

- **a.** For more complex issues, the examination will be conducted as an office examination at the appropriate IRS District Office by a tax auditor.
- **b.** The taxpayer will be asked to bring particular records to support items claimed on the return.
- **c.** Generally, the scope of the office examination is limited to the issues stated in the notification letter sent to the taxpayer.

4131.05 Types of examinations: Field examinations

a. If the tax issues are more complex, the IRS generally conducts a field examination.

b. In this situation, the IRS examiner, a revenue agent, goes to the taxpayer's place of residence or business to examine the taxpayer's records. The revenue agent is also authorized to take related testimony and to administer oaths.

c. A field examination is open-ended. The revenue agent may investigate any questionable items on the taxpayer's return (not only those previously identified) or any questionable items in the taxpayer's records.

4131.06 Audit process

a. Before the start of an examination, the IRS is required to provide the taxpayer with an explanation of the audit process and the rights available to the taxpayer. The taxpayer must also be informed that the taxpayer can suspend the interview at any time to consult with a representative.

b. A taxpayer may represent themselves or they may be represented by a CPA, an attorney, an enrolled agent, or the preparer of the return who signed the return as the preparer.

c. The taxpayer must give a representative written authority to represent them. This is generally done by use of IRS Form 2848 (*Power of Attorney and Declaration of Representative*).

d. At the conclusion of the exam, the tax auditor or revenue agent provides the taxpayer with any proposed adjustments of tax liability and any tax balance due.

e. If the taxpayer agrees with the adjustments, the taxpayer will sign an IRS Form 870 (*Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*). By signing this form, the taxpayer waives the right to receive a statutory notice of deficiency (90-day letter) needed to petition the Tax Court and also gives up the right to go to the IRS Appeals Division.

f. If the taxpayer does not agree with the adjustments, the taxpayer will receive a 30-day letter notifying them of the right to appeal the proposed adjustment to the IRS Appeals Office within a 30-day period. If an appeal is not requested, the taxpayer is issued a Notice of Deficiency (90-day letter), which gives them 90 days in which to file a Tax Court petition.

4131.07 Appeals process

a. An oral request for an Appeals conference can be made in the case of an office examination or a correspondence examination.

b. In the case of a field examination, a written request is necessary in order to have the case sent to the IRS Appeals Office.

c. If the proposed adjustment in tax for a particular period is $25,000 or less, the taxpayer only has to file a small case request indicating the adjustments they disagree with and stating the reasons for disagreement.

d. If the total amount of proposed adjustment in tax for a particular period is over $25,000, a formal written protest is required.

e. The written protest must include:

(1) a list of the proposed changes that the taxpayer does not agree with and the reason for disagreement,

(2) the tax periods involved,

(3) a statement of facts supporting the taxpayer's position, and

(4) a statement of the law or other authorities that the taxpayer relies upon.

f. The Appeals Division will settle disputes based on the hazards of litigating the issues in court.

Example: The taxpayer will have to weigh the cost of appealing against the amount of the tax owed. Furthermore, the Appeals Division can raise additional issues.

g. If a taxpayer agrees to settle the case with the Appeals Division, they will sign an IRS Form 870-AD (*Offer of Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment*). Acceptance of this form means that the case will not be reopened unless there has been fraud, misrepresentation of a material fact, a significant error in a mathematical calculation, or other administrative wrongdoing.

h. If a settlement is not reached with the Appeals Division, a statutory notice of deficiency (90-day letter) is sent to the taxpayer. This gives the taxpayer the opportunity to file a petition, within 90 days, with the Tax Court. The 90-day period is statutory. *No* extension of the time can be granted by the Tax Court. A case in the Tax Court is heard without payment of the tax. If the taxpayer loses, the taxpayer pays the tax with interest. If the 90-day *statutory* period is missed, the taxpayer *must* pay the tax and sue for a refund in the U.S. District Court or the U.S. Court of Federal Claims. To assure receipt by the Tax Court, the petition should be sent by registered mail; this is not required, but it is prudent.

Example: If the alleged tax owed is high, a taxpayer's better option is to file in the Tax Court and defer paying the tax until after the judgment of the Tax Court, rather than to liquidate assets to pay the tax and file for a refund.

4131.08 Judicial process

a. After a taxpayer has exhausted their administrative remedies with the IRS, the taxpayer may generally litigate the case in court.

b. All cases must start at the trial court level. For a federal tax dispute, there are three trial courts in which the case may be heard:

(1) Tax Court

(2) U.S. District Court

(3) U.S. Court of Federal Claims

c. If either the government or the taxpayer does not agree with the trial court's decision, the case may be appealed to either the appropriate U.S. Court of Appeals or the U.S. Court of Appeals for the Federal Circuit.

4131.09 Trial court: U.S. Tax Court

a. The U.S. Tax Court hears only federal tax disputes. The Tax Court is officially located in Washington, D.C., but judges travel to various cities across the United States to hear cases.

b. Generally, the case is heard by one judge. There are no juries in the Tax Court.

c. The Tax Court is a "deficiency court" in that the taxpayer can have the Tax Court hear their tax dispute without first paying the tax deficiency.

d. Appeals from the Tax Court go to the U.S. Court of Federal Appeals that covers the geographic area in which the taxpayer resides.

e. The Tax Court also has a simplified small tax case procedure that is more informal and where cases are heard by magistrates. To have a case heard in a small tax case procedure, the amount of tax in dispute cannot exceed $50,000. The taxpayer can elect this option in lieu of the U.S. Tax Court; however, there is *no* appeal from a small tax case procedure decision.

4131.10 Trial court: U.S. District Court

a. A taxpayer can also have their tax dispute heard by the U.S. District Court for the federal district in which they reside. The United States is divided into 11 regional Court of Appeal circuits. Each Circuit is then subdivided into Districts.

b. To have the case heard by the U.S. District Court, the taxpayer must first pay the tax and then sue the government in the District Court for a refund.

c. In District Court, one judge hears the case, and the taxpayer may also request a jury trial.

d. The District Court hears both tax and nontax cases.

e. Appeals from the U.S. District Court go to the U.S. Court of Federal Appeals for the geographic area in which the taxpayer resides.

4131.11 Trial court: U.S. Court of Federal Claims

a. The U.S. Court of Federal Claims generally hears cases in Washington, D.C. There is one judge and no jury.

b. This trial court hears cases involving claims (tax and nontax) against the federal government. Therefore, the taxpayer must first pay the tax and sue for a refund in this court.

c. Appeals from the U.S. Court of Federal Claims are heard by the U.S. Court of Appeals for the Federal Circuit, which sits in Washington, D.C.

4131.12 Trial court: U.S. Federal Court of Appeals

a. An appeal can be filed with the appropriate U.S. Federal Court of Appeals as a matter of right by either the taxpayer or the government if they disagree with the trial court decision. This means the appeals court must hear the appeal as long as proper procedures are followed in filing the appeal.

b. Normally the appeal is heard by a three-judge panel. In certain cases, all of the judges of the Circuit may hear the case and take part in the decision.

c. The trial courts whose decisions are appealable to a particular Court of Appeals are bound to follow the prior decision of the appellate court on the same issue.

d. One Court of Appeals, though, is not bound to follow a decision of another Court of Appeals on the same issue.

e. The Court of Appeals hears appeals of both tax and nontax cases from the trial courts.

f. Decisions of the U.S. Federal Courts of Appeals are appealable to the U.S. Supreme Court.

4131.13 U.S. Supreme Court

a. Either the taxpayer or the government can request that the U.S. Supreme Court review a decision in a tax case which has been rendered by a U.S. Court of Appeals. There is no appeal as a matter of right to the U.S. Supreme Court in a federal tax case.

b. To file an appeal, the taxpayer or the government must file a writ of certiorari requesting that the Supreme Court hear the case.

c. The Supreme Court generally does not hear appeals of tax cases. The situations in which the Court grants the writ of certiorari and hears the appeal in a tax case will usually involve either a situation in which the Courts of Appeals have issued opinions that are in conflict, the tax issue in the case impacts a large number of taxpayers, or the tax issue involves a large amount of tax revenue.

d. If the Supreme Court grants the appeal and renders a decision in the case, this is generally the final word on the issue (unless Congress acts legislatively). All of the lower courts, trial and appellate, must follow the Supreme Court decision in future cases.

4132 Substantiation and Disclosure

Substantiation

4132.01 Substantiation requirements (in general)

a. A taxpayer must generally be able to substantiate any item on their tax return if an issue is raised regarding the item by the IRS.

b. In addition to the general requirement that all items must be able to be substantiated, the Internal Revenue Code, regulations, and other tax pronouncements contain numerous rules regarding the specific substantiation requirements for certain types of deductions or credits taken on a taxpayer's return.

c. While including all of the situations where specific substantiation requirements are laid out in the tax rules is beyond the scope of this outline, two examples follow in sections **4132.02** and **4132.03.**

4132.02 Substantiation of medical expenses

a. All taxpayers may deduct only the amount of the total unreimbursed allowable medical care expenses for the year that exceeds 7.5% of their adjusted gross income.

b. To substantiate these medical expenses, a statement or itemized invoice should be retained that shows:

(1) the name and address of each person or entity paid,

(2) the amount and date of each payment, and

(3) what medical care was received and who received it.

4132.03 Substantiation of charitable contributions

a. For cash contributions, a deduction is only allowed if the taxpayer has written receipts such as a canceled check or a written statement from the charity that show:

(1) the name of the charity and

(2) the date and amount of the contribution.

b. A written statement must provide an estimate of the value of any goods or services received by the donor if:

(1) a payment is made to the charity for more than $75 and

(2) the payment is partly a charitable contribution and partly a payment for goods and services.

c. For gifts of property other than money, the taxpayer must have a receipt from the charity. If the property is clothing or other household items, the property must in "good used condition or better."

d. To deduct a single cash or noncash property contribution of $250 or more, the taxpayer must receive a written acknowledgment from the charity. The acknowledgment must include:

(1) the amount of cash received or a description of the noncash property contributed,

(2) whether or not the charity provided the donor any goods or services for the contribution, and

(3) a description and estimate of the value of any goods or services that were provided.

e. If the taxpayer donates noncash gifts valued at more than $500, additional substantiation must be provided with the taxpayer's return. This includes:

(1) how the property was acquired and

(2) the taxpayer's basis in the property.

f. If a taxpayer makes a noncash contribution that exceeds $5,000 in value, a qualified appraisal regarding the value of the property may also be required.

g. If a taxpayer donates a used car to a charity, the taxpayer must obtain a statement from the charity stating the sales price of the car in cases where the car is sold by the charity. The amount that the charity receives from selling the car generally is the amount that the taxpayer can deduct for contributing the car to the charity.

Required Disclosure of Tax Return Positions

4132.04 Required disclosure of tax return positions (in general)

a. In IRS Schedule UTP, certain companies are required to disclose specific information regarding uncertain tax positions taken on their tax return.

b. Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation on its U.S. federal income tax return if the following two conditions are met:

(1) The corporation has taken a tax position on its federal income tax return for the current tax year or a prior tax year.

(2) Either the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that tax position because the corporation expects to litigate the position.

c. A tax position meeting one of the two above criteria must be reported regardless of whether the audited financial statements are prepared based on U.S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or other country-specific accounting standards, including a modified version of any of the above.

d. A tax position taken on a tax return is a tax position that would result in an adjustment to a line item on that return if the position is not sustained. If multiple tax positions affect a single line item, each tax position must be reported separately on the Schedule UTP.

e. Analysis of whether a reserve has been recorded for the purpose of completing Schedule UTP is determined by reference to the reserve decisions made by the corporation or related party for audited financial statement purposes.

f. A corporation is not required to report on Schedule UTP, a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded with respect to that tax position in audited financial statements issued in 2010 or later.

4132.05 Who must file

a. A corporation must file Schedule UTP with its income tax return if:

(1) the corporation files IRS Forms 1120, 1120-L, or 1120-PC,

(2) the corporation has assets that equal or exceed $10 million,

(3) the corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and

(4) the corporation has one or more tax positions that must be reported on Schedule UTP.

b. The Schedule UTP should not be filed separately but should be attached to the corporation's income tax return.

4132.06 Policy of restraint

a. The IRS has announced that it will use a policy of restraint and forgo seeking certain documents that relate to uncertain tax positions and the workpapers that document the completion of IRS Schedule UTP.

b. If a document is otherwise privileged under the attorney-client privilege, the tax advice privilege in IRC Section 7525, or the work product doctrine and the document was provided to an independent auditor as part of an audit of the taxpayer's financial statements, the IRS will not assert during an examination that privilege has been waived by such disclosure.

c. The above will not apply if:

(1) the taxpayer has engaged in any activity or taken any action, other than those described in that paragraph, that would waive the attorney-client privilege, the tax advice privilege in IRC Section 7525, or the work product doctrine; or

(2) a request for tax accrual workpapers is made because unusual circumstances exist, or the taxpayer has claimed the benefits of one or more listed transactions.

d. Under current procedures, examiners request tax reconciliation workpapers as a matter of course. The taxpayer may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP it is asked to produce during an examination:

(1) Working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP

(2) The amount of any reserve related to a tax position reported on Schedule UTP

(3) Computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position

e. Other than requiring the disclosure of the information on the schedule, the requirement to file Schedule UTP does not affect the policy of restraint.

4132.07 **Reportable transactions:** The United States Congress has enacted a series of income tax laws designed to halt the growth of abusive tax avoidance transactions, including the disclosure of reportable transactions. Each taxpayer that has participated in a reportable transaction and that is required to file a tax return must disclose information for each reportable transaction in which the taxpayer participates.

According to the instructions for IRS Form 8886, reportable transactions include the following:

a. Transactions, or substantially similar transactions, identified by the IRS through notice, regulation, or other form of published guidance as a listed transaction

b. **Confidential transactions:** A confidential transaction is a transaction that is offered to the taxpayer or a related party under conditions of confidentiality and for which the taxpayer or a related party paid an advisor a minimum fee. A transaction is considered to be offered under conditions of confidentiality if the advisor places a limitation on the taxpayer’s disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of the advisor's tax strategies.

c. **Transactions with contractual protection:** This is a transaction for which the taxpayer or a related party has the right to a full refund or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained.

d. **Loss transactions:** A loss transaction is a transaction that results in a taxpayer claiming a loss under IRC Section 165 (a loss due to a non-reimbursed insurance claim).

e. **Transactions of interest,** which are similar to transactions that the IRS has identified by notice, regulation, or other form of published guidance as a listed transaction, but for which there is not enough information to determine if the transaction should be identified as a tax avoidance transaction

4133 Taxpayer Penalties

4133.01 Failure to file and failure to pay

a. If a taxpayer fails to file a tax return by the due date, including any extension, a penalty of 5% per month (up to a maximum of 25%) is imposed on the amount of tax shown as being due on the return.

b. If the failure to file is due to fraud, the penalty is 15% per month (up to a maximum of 75%).

c. If a taxpayer fails to pay the tax shown as due on the return, a penalty of 0.5% per month (up to a maximum of 25%) is imposed on the tax due. The penalty amount is doubled if the taxpayer fails to pay the tax once a deficiency assessment has been made.

d. During any month in which both the failure to file and failure to pay penalties are applicable, the failure to file penalty is reduced by the amount of the failure to pay penalty.

e. These penalties do not apply if the taxpayer can show that either the failure to file or failure to pay was due to reasonable cause, not willful neglect.

f. In *Haynes and Haynes v. United States,* the Western District Court of Texas held that previously decided late-filing penalty cases are not limited to only paper returns. The Court ruled that electronically filed tax returns are subject to the same set of standards as paper returns, and reasonable cause exceptions to the late-filing penalty are the same for both paper and electronically filed returns.

4133.02 Failure to pay estimated tax

a. A penalty can be imposed on a taxpayer who fails to pay a sufficient amount of estimated income taxes. The amount of the penalty is based on the interest rate in effect at the time for deficiency assessments.

b. The penalty is not applied if the tax due for the year after withholding and credits is less than $500 for corporations or $1,000 for all other taxpayers.

c. For an individual, the underpayment of estimated tax is the difference between the estimated tax paid and the lowest of:

(1) 90% of the current year's tax,

(2) 100% of the prior year's tax, or

(3) 90% of the tax that would be due on an annualized income computation for the period that runs through the end of the quarter.

If the prior-year AGI of the taxpayer exceeds $150,000 ($75,000 if married filing separate), the 100% above becomes 110%.

d. A corporation's underpayment of estimated tax is generally the difference between the estimated taxes paid and the lowest of:

(1) the current-year tax,

(2) the prior-year tax, or

(3) the tax on an annualized income computation using of one of three computation methods allowed by the Internal Revenue Code.

e. Any fines and/or penalties paid are not allowed as deductions on the tax return.

4133.03 Accuracy-related penalties

a. The accuracy-related penalty combines several related penalties so that multiple penalties will not apply to a single understatement of tax.

b. Each of the accuracy-related penalties is 20% of the portion of the tax underpayment attributable to:

(1) negligence or disregard of rules and regulations,

(2) substantial understatement of tax liability,

(3) substantial valuation overstatement, or

(4) substantial valuation understatement.

c. The penalty will not apply if the taxpayer can show a reasonable basis for the position that was taken on the return.

d. Interest on the accuracy-related penalty runs from the due date of the return, including extensions, until the penalty is paid.

e. The negligence penalty will apply to an underpayment that is attributable to a failure to make a reasonable attempt to comply with the tax law. A taxpayer is automatically considered negligent if they fail to report income that is covered by an information return (IRS Form 1099) filed by the payor with the IRS.

f. A substantial understatement of tax liability occurs if the understatement exceeds the larger of 10% of the tax due or $5,000:

(1) For a C corporation, a substantial understatement is the lesser of 10% of the tax due (at least $10,000) or $10 million.

(2) In all cases, the understatement to which the penalty applies is the difference between the amount of tax shown on the return and the amount of tax that should have been shown.

(3) The penalty can be avoided if:

(a) the taxpayer has substantial authority for the position taken or

(b) there is adequate disclosure of the position taken on the IRS Form 8275 attached to the return.

g. Substantial valuation overstatement:

(1) The penalty is 20% of the additional tax that should have been paid if the correct value of the property had been used.

(2) The penalty applies only if the valuation used is 150% or more of the correct valuation. The penalty is doubled if the taxpayer makes a gross overvaluation (200% or more).

(3) The penalty only applies when the income tax underpayment that results from the overvaluation exceeds $5,000 ($10,000 for a C corporation).

h. Substantial valuation understatement:

(1) An accuracy penalty can be imposed for an estate or gift tax valuation understatement.

(2) The penalty is 20% of the additional estate or gift tax that would be due if the correct valuation had been used.

(3) The penalty is imposed only if the value of the property claimed on the return is 65% or less than the correct valuation.

(4) The penalty is doubled if the taxpayer makes a gross undervaluation (the reported value is 40% or less than the correct value).

(5) The penalty only applies if the additional estate or gift tax liability exceeds $5,000.

4133.04 Civil fraud penalty

a. A 75% civil penalty is applied to any underpayment of tax resulting from fraud by the taxpayer.

b. If the fraud penalty is applicable, then the accuracy-related penalty is not applied to the same portion of the underpayment of tax.

4133.05 Penalty on erroneous refund claims

a. If a taxpayer files a claim for refund that is greater than the amount actually allowable, a penalty equal to 20% of the improperly claimed amount applies.

b. The penalty does not apply if the taxpayer can show that they had a reasonable basis for the excessive refund claim.

4133.06 False information: Withholding

a. A civil penalty of $500 applies if a taxpayer claims withholding allowances that are based on false information.

b. A criminal penalty can also apply to a willful failure to supply information or for willfully supplying false or fraudulent information regarding withholding. The penalty is an additional fine of up to $1,000 and/or up to one year in prison.

4133.07 Failure to deposit taxes

a. A penalty can be applied if there is a failure by the taxpayer to deposit amounts withheld from employee wages for FICA and income tax.

b. A penalty of up to 15% of any under-deposited amount can be imposed unless the employer can show that the failure was due to reasonable cause and not due to willful neglect.

c. If the action of the employer is willful, a 100% penalty can be imposed on any "responsible person" of the business. While there may be several persons who meet the definition of a "responsible person," the IRS may not collect more than the total amount due.

4133.08 Criminal penalties: The criminal tax penalties in the Internal Revenue Code include the following:

a. Willful attempt to evade or defeat tax: The maximum penalty is a $100,000 fine and/or five years in prison. For a corporation, there is no imprisonment, but the maximum fine is $500,000.

b. Willful failure to collect or account for and pay over tax: The maximum penalty is $10,000 fine and/or five years in prison.

c. Willful failure to pay a tax or an estimated tax, to file a required return, to keep required records, or to provide required information: The maximum penalty is a $25,000 fine and/or one year in prison. For a corporation, there is no imprisonment, but the maximum fine is $100,000.

d. Willfully furnishing an employee with a false statement regarding tax withholding on wages: The maximum penalty is a $1,000 fine and/or one year in prison.

e. Making a knowingly false declaration under penalty of perjury, preparing or assisting in preparation of a fraudulent return or other documents, or concealing goods or property in respect of any tax: The maximum penalty is a fine of $100,000 and/or three years in prison.

4134 Authoritative Hierarchy

4134.01 Assessing tax sources

a. When conducting tax research, the first step is locating sources of tax authority that have a bearing on the tax issue being researched.

b. Once the sources are located, it is important to assess the sources and determine the authoritative hierarchy of the sources that have been found.

4134.02 Legislative sources

a. The Internal Revenue Code (IRC) is the ultimate authoritative source since it is the tax law enacted by Congress. All other tax sources are simply interpreting what Congress intended by the language that was used in the statute.

b. If the Code provides the answer to the researcher's question, no other tax sources are necessary. However, in most cases, the researcher must consult other tax sources in order to determine the scope of the applicable Code section.

c. The legislative history behind the Code section is also a valuable source because it often answers questions regarding the intent of Congress in enacting the Code section and the scope of the Code section itself.

d. The legislative history is found in the:

(1) House Ways and Means Committee Report,

(2) Senate Finance Committee Report, and

(3) Joint Conference Committee Report (if one exists).

4134.03 Administrative sources

a. The Treasury Regulations are the official interpretation of the Internal Revenue Code by the Department of the Treasury. The regulations are the administrative source of tax authority that carry the most weight.

b. Regulations are given great deference by the courts if the taxpayer ends up litigating their tax dispute with the government. This is because the regulations are the interpretation of the Code by the government department responsible for administering the tax law.

c. A court will generally only invalidate a regulation if the taxpayer can convince the court that the regulation does not clearly reflect the intent of Congress in enacting the Code section.

d. The second most important source of administrative tax authority is revenue rulings.

e. Revenue rulings carry far less weight than regulations. This is because a Revenue Ruling is issued by the Internal Revenue Service and is therefore viewed as the position of the IRS on a particular tax issue.

f. Revenue rulings are therefore easier to challenge in court. As a result, finding a revenue ruling that conflicts with the position of the taxpayer may not be fatal. It does, however, show the IRS position on the issue.

g. Other administrative tax sources generally carry less weight than regulations and revenue rulings. However, in a given situation, one of these other sources may be very valuable to the taxpayer position in question. These other administrative sources include the following:

(1) Revenue Procedures

(2) Letter Rulings (These technically cannot be cited as authority by any taxpayer other than the taxpayer requesting the ruling; note, however, that letter rulings have been cited by courts, including Courts of Appeals.)

(3) Treasury Decisions

(4) Determination Letters

(5) Technical Advice Memoranda

4134.04 Judicial sources

a. Generally, the higher the level of the court that rendered a decision, the greater the weight the decision should be given.

b. A decision rendered by the U.S. Supreme Court is the definitive answer on a tax issue. The only way that the rule laid down by a Supreme Court decision can be impacted is if Congress disagrees with the Supreme Court's interpretation and changes the tax law by amending the Internal Revenue Code.

c. A decision rendered by a court of appeals (e.g., the Sixth Circuit Court of Appeals) should generally be given more weight than a decision rendered by a trial court (e.g., a U.S. Federal District Court).

d. Regarding the Tax Court, a reviewed decision of the Tax Court (in which all the Tax Court judges participate) should generally carry greater weight than a normal Tax Court decision (decided by a single Tax Court judge).

e. The geographic location of the court rendering the decision should also be factored into the weight given to the case. More weight should be given to an opinion from a court in which the taxpayer could possibly have his case heard. For example, a taxpayer located in Florida should put more weight on an opinion from the Eleventh Circuit Court of Appeals than one from the Sixth Circuit Court of Appeals because Florida is located in the Eleventh Circuit.

f. Finally, if a court opinion is consistent with decisions rendered by other courts, that opinion should be given more weight than an opinion not supported by other decisions.

4140 Legal Duties and Responsibilities

4141 Common Law Duties and Liability to Clients and Third Parties

Liability to Clients Under Common Law

4141.01 The CPA may be held liable to clients in an audit, taxation, or consulting services engagement for the following:

a. Fraud

b. Gross negligence or constructive fraud

c. Negligence (ordinary or simple)

d. Breach of contract

4141.02 **Fraud** is an *intentional* misrepresentation of a material fact with resultant harm to another party, intending to result in financial or personal gain.

4141.03 **Gross negligence** (constructive fraud) is *extreme, flagrant, or reckless departure* from the standards of due care and competence in performing or reporting upon professional engagements.

a. There need not be actual intent to deceive (scienter).

b. Fraud may be inferred from sloppy performance (e.g., CPA omits a vital procedure such as a bank reconciliation in order to save time).

4141.04 **Negligence** (ordinary or simple) is the failure to do what an ordinary, reasonable, prudent CPA would do in similar circumstances.

a. To establish negligence, the plaintiff (client) must establish the following:

(1) The defendant (CPA) owed a legal duty.

(2) The CPA breached that duty.

(3) The CPA's action was the proximate cause of the resulting injury to the client.

(4) The CPA's actions caused damage (loss).

b. CPAs are not liable for an honest error in judgment as long as they act with reasonable care.

4141.05 The CPA's responsibility to the client is determined by the applicable State Board of Accountancy. Such authorities increasingly rely on the profession's standards, as defined by:

a. generally accepted auditing standards (GAAS) and/or specific terms of the contract for attest services,

b. AICPA Statements on Standards for Tax Services and Treasury Circular 230 for tax compliance services, and

c. AICPA Statements on Standards for Consulting Services for management advisory services.

4141.06 Greater responsibility may be assumed by an express contract that goes beyond the professional standard.

4141.07 The agreement between the CPA and the client should be expressed in writing in an engagement letter. The engagement letter, written to the client on the CPA's letterhead, should provide a place for the client to indicate agreement with the terms of the undertaking via the client's signature. An important case on this point is *1136 Tenants' Corporation*. Because the CPA firm did not have an engagement letter, it was found liable for $237,000 (relative to a $600 annual fee) of damages for failure to discover defalcations. The CPA firm contended that the engagement called for preparation of unaudited financial statements, not an audit. The plaintiff was successful in establishing that an audit was agreed upon.

4141.08 Many legal actions by clients involve claims based upon failure to discover a theft or, more commonly today, bad tax advice or failure to identify a tax compliance issue.

Defenses

4141.09 Defenses available to the CPA include the following:

- **a.** The CPA was not negligent or fraudulent.
- **b.** Contributory negligence of the client caused the loss.
- **c.** The CPA adhered to professional standards.
- **d.** The error was immaterial.
- **e.** The proximate cause of loss was not the CPA's error.

4141.10 **Tax return preparer liability.** A client may be able to sue the CPA who prepared a tax return that caused the client to incur penalties or other sanctions due to the CPA's wrongful action. Basis of liability could be breach of contract or the tort of negligence.

4141.11 For taxation engagements, while many claims arise from the CPA's failure to meet a filing date for a tax return, some of the largest claims allege failure to properly apply the law to a transaction.

- **a.** The CPA may be liable for interest on late payment *plus* penalty.
- **b.** The CPA may be liable for interest, penalty, *and* tax if the client can prove erroneous tax advice rendered by the CPA.

Liability to Third Parties Under Common Law: Ultramares Rule

4141.12 The CPA may be held liable to third parties for any of the following:

- **a.** Fraud
- **b.** Gross negligence

4141.13 Under common law, CPAs have not (until recently) been found liable to those not in privity on the theory of ordinary negligence.

- **a.** Third parties include investors and creditors.
- **b.** The term "privity" refers to a contractual or near contractual relationship.

4141.14 In 1931, the common-law Ultramares rule was promulgated. The court in *Ultramares* stated that where a CPA recklessly certifies to the truth of financial statements without taking the proper procedures to determine whether or not the financial statements are in fact true, a jury might find the CPA guilty of fraud.

- **a.** *Ultramares* developed a concept of gross negligence or constructive fraud.
- **b.** According to *Ultramares*, the third party that proves gross negligence will be successful in reaching the CPA without regard to privity.
- **c.** Gross negligence is a deceit that involves a misrepresentation of a material fact, with lack of reasonable ground for belief, relied upon by another, which causes damage to that party.
- **d.** *Ultramares* refused to hold a CPA liable to third parties for simple negligence.

4141.15 *Ultramares* is still a good precedent in some jurisdictions; however, in many states substantial inroads have been made on *Ultramares* through creation of the following rules.

Liability to Third Parties Under Common Law: Third-Party Beneficiary Rule

4141.16 The CPA may be held liable for ordinary negligence by third parties when the CPA knows that the services for a client are *primarily* for the benefit of a third party.

4141.17 When the services are primarily for the benefit of a third party, the third party is, in effect, a party to the contract.

4141.18 In order for plaintiff to be a third-party beneficiary, the *aim* and *end* of the transactions must be to benefit the third party.

Liability to Third Parties Under Common Law: Foreseeability Rules

4141.19 A CPA who is negligent in issuing the report can be liable to third parties who can be foreseen as being injured.

4141.20 According to the foreseen user rule applied by some courts, if a CPA is retained by a client to perform an audit examination for purposes of obtaining a bank loan from Fourth National Bank, the bank may successfully recoup loan losses by proving that the CPA was negligent (if the bank, in fact, relied upon the audited financial statements).

4141.21 Under the foreseen class of users rule applied by some courts, *any* bank creditor in reliance upon the negligently audited financial statements proving negligence will be successful.

4141.22 On the other hand, a trade creditor or an investor is not foreseen; therefore, such third-party users in the bank loan situation would have to prove fraud or constructive fraud in order to reach the CPA. They could not recover based on simple negligence.

4141.23 According to *Restatement of Torts,* the plaintiff (third party) does not have to be identified by a specific person to the accountant but only has to be identified by class (e.g., bank credit). This follows the foreseen class of users rule. The *Restatement of Torts* is an attempt by the American Law Institute "...to present an orderly statement of the general common law of the United States, including in that term not only the law developed solely by judicial decision, but also the law [that] has grown from the application by the courts of statutes...." (*Restatement, Torts* viii, ix (1st ed.))

4141.24 In recent years, a few courts have applied a foreseeable users test. For CPAs to be liable, it is only necessary that they generally could expect or foresee the use of their work product by the third party in question.

4141.25 The following matrix summarizes what the plaintiff (third party) must prove to successfully reach the defendant (CPA) for fraud, gross negligence, and simple negligence.

	Fraud	Gross Negligence	Simple Negligence
False representation	*	*	*
Awareness	Knowledge	Reckless disregard	Failure to exercise care
Intention to induce reliance	*	X	X
Justifiable reliance	*	*	*
Resultant damage	*	*	*

* = Plaintiff must prove
X = Not essential

4141.26 Common law varies from state to state; thus, some jurisdictions are *Ultramares* states while others apply the foreseeability doctrine. Both alternatives should be presented in responding to a CPA Examination question. An *Ultramares* state, of course, ignores the foreseeability rule and requires the third-party plaintiff to establish fraud or gross negligence.

Liability to Third Parties Under Common Law: Unaudited Financial Statement Liability

4141.27 A third party in a common-law suit involving unaudited financial statements must prove that the CPA was either fraudulent or grossly negligent in order to successfully reach the CPA.

4141.28 The concept of foreseeability has yet to be applied to unaudited financial statements.

4142 Privileged Communications, Confidentiality, and Privacy Acts

Communications With or on Behalf of Clients

4142.01 How much detail should be included in communication with or on behalf of clients, and how technical the communication should be, will be determined by the audience. Communication addressed to a taxpayer with little tax knowledge should obviously be much less detailed and technical than a communication directed toward an IRS agent or a superior within the researcher's accounting firm.

4142.02 Generally, a communication should include the following elements:

- **a.** A brief statement of the essential facts necessary to answer the tax question(s)
- **b.** The identification of the tax issue(s). If there are multiple tax issues to be researched, each issue should be separately laid out for clarity.
- **c.** A clear identification of the conclusion(s) reached by the researcher. A separate conclusion should be stated for each tax issue. Also, if more than one conclusion may exist due to a conflict in the tax authorities, this should be clearly communicated.
- **d.** A clear statement of the tax sources on which the conclusion was based and the reasoning that supports the conclusion

Privileged Communications

4142.03 In common law, there is *not* a privilege that an accountant or client may invoke to prevent disclosures.

4142.04 About 36 states have adopted statutes creating an accountant-client privilege. The statutes vary as follows:

- **a.** Some apply only to CPAs, while others extend to all public accountants.
- **b.** Some provide that the privilege is not applicable to criminal or bankruptcy actions.
- **c.** Some exclude certain services such as auditing.
- **d.** Some statutes do not state clearly whether the client or the CPA has the benefit of the privilege. Usually, the privilege belongs to the client and the client is in control of whether or not the information is disclosed by the CPA.

4142.05 There is no general *federal* accountant-client privilege.

- **a.** Generally, any state-created accountant-client privilege is *not* recognized for federal law purposes.
- **b.** Under Internal Revenue Code (IRC) Section 7525, however, a privilege is available for communication between a federally authorized tax practitioner (e.g., a CPA, attorney, enrolled agent, or enrolled actuary) and a client or potential client.
  - (1) This privilege can only be asserted in either of the following:
    - (a) Noncriminal tax matters before the Internal Revenue Service
    - (b) Noncriminal tax proceedings in federal court brought by or against the United States
  - (2) Tax advice is advice given with respect to a matter that is within the scope of the tax practitioner's authority to practice before the IRS.
  - (3) The privilege exists only to the extent the communication would be privileged under the attorney-client privilege if the communication had been made between a client and an attorney.
  - (4) The privilege does not apply to any written communication between a tax practitioner and a corporate representative (including a director, shareholder, officer, employee, or agent) concerning the corporation's participation in any tax shelter (as defined in IRC Section 6662(d)(c)(iii)).

4142.06 The AICPA *Code of Professional Conduct* mandates a *confidential relationship* but not *privileged communication.*

CPA's Workpapers

4142.07 The CPA must generally keep the information in the workpapers confidential. CPAs are independent contractors, not employees; thus, they have legal title to their workpapers. The workpapers do not belong to the client; however, the CPA's ownership of the workpapers is custodial. This means the accountant cannot generally transfer them to a third party without the client's permission. Exceptions include subpoena by a federal court or agency or inspection by an AICPA or state society quality review team.

4142.08 A seller of an accounting practice has a duty to obtain permission of the client before making workpapers available to a purchaser of the practice. CPAs do not have a common-law lien on client workpapers coming into their possession.

4142.09 A deceased partner can convey workpapers to copartners.

Section 4200
Business Law
(15% - 25%)

4210 Agency

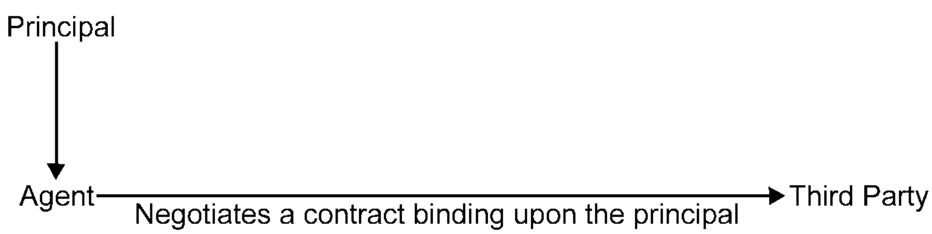
4211 Overview

4211.01 An *agency* is a fiduciary relationship between two persons when one person (the agent) acts for the benefit and under the control of the other person (the principal) and has the power to affect the legal relationships of the principal.

4211.02 The word *person* is used in the legal sense. A corporation, a partnership, or an individual can be a person and can therefore act in the capacity of either a principal or an agent.

4211.03 The relationship is consensual. Both persons must consent to enter into an agency relationship. Consent can be expressed or implied from the conduct of the parties.

4211.04 The agency relationship can be shown as follows:



4211.05 Agency law involves the following relationships:

a. Principal and agent

b. Employer (master) and employee (servant)

c. Principal and independent contractor

4211.06 If a principal/agent relationship exists, the agent will also be viewed as either an employee or an independent contractor.

4211.07 The word *agent* is often used interchangeably with the word *employee (servant).* However, not every employee is an agent; only an employee who is also an agent can make contracts with third parties for the principal (the employer).

4211.08 Agency is used by the principal to expand activities. A corporation, being an artificial entity created by government authorization, can act only through agents. In partnerships, each partner can act as an agent for the partnership entity. A sole proprietor hires agents so that the sole proprietor can transact more business.

4211.09 The agency relationship can be used in either business or personal situations.

4211.10 **Formalities.** No particular formalities are required to form the agency relationship. The formation can be oral, written, or the agency can be created by some conduct of the principal that may be interpreted by a third party as an intention to appoint an agent. If formed by contract, it must satisfy the requirements of a contract. The statute of frauds requires an agency contract to be in writing to be enforceable if the contract cannot be performed within one year from the time of making the contract.

Power of attorney. A power of attorney is a formal instrument, usually acknowledged by a notary public, to confer authority on an agent. The agent is referred to as an attorney-in-fact, to distinguish them from a lawyer who is an attorney-at-law.

Agency Relationships

4211.11 **Principal and agent.** The agent works for the benefit and under the control of the principal and has the right to represent the principal and make contracts with third parties on behalf of the principal.

- **a.** The agent must be either an employee or an independent contractor (but not all employees or independent contractors are agents).
- **b.** The principal is liable on contracts made by an agent if the agent has authority to act on behalf of the principal.
- **c.** The principal is not liable on contracts made by an employee or independent contractor unless that person is also an agent.
- **d.** The principal may be held liable for torts against third parties committed by agents who are employees of the principal, but not for torts committed by independent contractors.
- **e.** **Example:** SAS Corporation hires Gerry to sell its products as an outside salesman. Gerry calls on customers and makes sales contracts with them. SAS Corporation would be the principal, Gerry would be an agent, and the customers would be third parties. Contracts entered between Gerry and the customers would generally be binding on SAS Corporation.

4211.12 **Employer and employee.** The employee works for the benefit and under the control of the employer but does not have the right to represent the principal or make contracts with third parties. Several factors are considered in determining if an individual is an employee. The most important of these is the right of the employer to control the physical details of the employee's work. An employee can be an agent if the employee is also given the authority to enter contracts with third parties that are binding on the principal.

Example: SAS Corporation hires Lila to be a production line worker. Lila would be an employee and SAS Corporation would be the employer. Lila is not an agent because she does not have the authority to represent her principal in dealing with third parties.

4211.13 **Principal and independent contractor.** The independent contractor acts for the benefit of the principal but not under the principal's control. The principal who deals with an independent contractor is sometimes called a proprietor. The principal contracts for the end result, but the principal has no right of direction or control while the activity is being performed. The principal is not usually liable for the torts of an independent contractor even though the independent contractor is acting for the principal at the time the tort occurred.

- **a.** **Example:** In conducting an audit for a client, the CPA acts as an independent contractor. The client seeks an opinion, but the CPA determines what is audited and how it is audited. If the client controlled the audit, the CPA would not have professional independence.
- **b.** **Example:** SAS Corporation hires Williams to repave its parking lot. Williams completes the work over the weekend with no involvement by SAS Corporation. Williams would be an independent contractor as to SAS Corporation because the principal exercised no control over the physical details of the work.

c. **Example:** Williams (in the prior example) hires individuals to work for him in his repaving business. Williams tells them what to do in repaving the SAS Corporation parking lot. These individuals would be employees of Williams since he has control over the physical details of the work they perform.

It is a question of fact as to what type of relationship exists between two persons. The question arises when there is a tort while the other person is acting for the benefit of the principal. Liability of the principal is determined by the control factor.

4211.14 **Franchiser and franchisee.** This relationship is normally that of principal and independent contractor. However, the relationship could be found to be that of employer and employee if the franchiser exercises significant control over the franchisee in running the franchise. The franchiser is not liable for the torts of the franchisee if the franchisee acts as an independent contractor.

Example: Fast-food restaurants are often franchise operations. Well-known examples are Wendy's, McDonald's, and Burger King. In most chains there are stores owned by the chain (employer-employee) and franchised stores (principal-independent contractor).

Creation of an Agency

An agency can be created by the following means:

4211.15 **Contract.** Both the principal and the agent contractually agree to the relationship. This is the usual way of creating the agency relationship.

Example: Harry agrees that he will sell the products of the Doyle Corporation for a 10% commission on the sale price.

4211.16 **Agreement but not a contract.** Both the principal and the agent agree to the relationship, but the agreement is not a contract because it lacks some of the required elements. The agreement can be shown by the principal's and agent's conduct.

Because it is not necessary that the agreement be a contract, consideration is not a requirement for creation of an agency.

4211.17 **Ratification.** Ratification occurs when the principal gives approval of an act previously done by the purported agent for the principal without authority. When the act happens, it must have been done for the purported principal, not for the purported agent. The ratification must also occur within a reasonable time.

- **a.** The principal can expressly ratify the unauthorized act by indicating the intent to be bound. Oral or written statements to either the third party or the agent can result in an express ratification.
- **b.** An implied ratification can result if the principal retains the benefits and advantages of the contract with the third party.
- **c.** Ratification retroactively acts as an acceptance by the principal of the unauthorized contract from the date the contract was made.
- **d.** Ratification cannot generally be retracted once done.
- **e.** The third party can withdraw from the contract before ratification by the principal, but not after.
- **f.** The entire contract must be ratified by the principal. Partial ratification of the favorable parts and rejection of the unfavorable parts of the contract are not permitted.

g. Ratification is possible only when the principal knows all the important terms of the contract.

4211.18 **Estoppel.** This is called creation of agency by *apparent* authority. This occurs when the principal leads a third party to reasonably believe that a person acts as the principal's agent. The principal is prohibited from denying the existence of an agency relationship if the third party deals with the person as the principal's agent. Technically, no agency relationship is created by estoppel, but the principal is legally liable as if there were an agency relationship. It must be the principal, not the agent, that leads the third party to believe that an agency relationship exists.

4211.19 **By operation of law.** An agency relationship can be imposed by operation of law in some unusual circumstances. These are examples:

a. **Necessity.** This happens by operation of law when an emergency situation develops and the agent is given power to act beyond normal authority. Usually these conditions exist when the following are true:

(1) The agent cannot contact the principal for instructions.

(2) Failure to act will cause substantial loss to the principal.

b. A spouse or child who purchases necessities for the family is the agent of the other spouse.

4211.20 Marriage itself does not create an agency relationship. One of the spouses can act as an agent for the other spouse, but it is not because of the marriage that the agency exists.

Example: A wife tells her husband to buy some goods from a particular store and charge the purchase price to her charge account. The husband is acting as an agent for the wife. Marriage is not the basis of the agency, rather the consent of the principal (wife) to have the husband (agent) act for her.

Classification of Agents

4211.21 **General agent.** An agent who is authorized to do a series of transactions for the principal for a continuing period of time. A general agent has much *implied authority*.

a. **Example:** Mildred hires Tom to operate her ice cream store. Tom is a general agent having implied authority to do many types of activities relating to the store.

b. **Example:** A business manager of a retail store, as a general agent, has implied authority to engage in such normal activities as the following:

(1) Buying and selling inventory

(2) Purchasing supplies and equipment

(3) Hiring and firing employees

However, that manager would lack implied authority to do such things as the following:

(1) Mortgaging the property

(2) Borrowing money from the bank

(3) Selling the business

The manager would not have implied authority to do these activities because they are *outside* the scope of the authority that a manager of a retail store would normally have.

4211.22 **Special agent.** An agent who conducts some specific transaction for the principal over a limited period of time. A special agent has less implied authority than a general agent. Examples of special agents include the following:

a. **Broker.** Brings the seller and buyer together. The broker is a special agent of one of the two parties and has very limited implied authority.

b. **Factor.** A factor receives possession of some other person's property to sell for a commission. The factor is a special agent, having only that implied authority that relates to the sale of the property. The factor is sometimes called a *commission merchant.* The factor receives a commission from the sale and sells in his/her own name.

c. **Lawyer.** A lawyer handles a particular case for the client. The lawyer is a special agent of the client and has only implied authority as it relates to the particular case.

d. **Auctioneer.** Person who auctions the seller's property. Once the property has been sold, the auctioneer acts as an agent for both the seller and the buyer to transfer legal title.

4211.23 **Gratuitous agent.** Person who agrees to act as an agent without expectation of compensation. The relationship is generally the same as in the case of a compensated agent, except that a gratuitous agent has no obligation to act for the principal unless the gratuitous agent has caused the principal to reasonably rely on the agent to perform the act.

Example: Dave wants to place a bid on property being sold at auction but is unsure that he will be able to be there in time. A friend, Bill, offers to go and place the bid on Dave's behalf. If Bill fails to go and make the bid, he may be liable to Dave because Dave reasonably relied on Bill placing the bid at the auction.

4211.24 **Compensated agent.** Person who agrees to act as an agent with expectation of compensation. This would be the assumed situation between unrelated persons.

4211.25 **Subagent.** Person appointed by an authorized agent to act for the agent. If the agent is authorized to appoint a subagent, the acts of the subagent are binding on the principal. If the agent lacks authority to appoint a subagent, the subagent's acts are not binding on the principal.

Classification of Principals

4211.26 **Disclosed principal.** A disclosed principal is a person whose existence and identity are known to the third party at the time of making the contract with the agent.

4211.27 **Partially disclosed principal.** A partially disclosed principal is a principal whose *existence* is known to the third party at the time of contracting with the agent. The specific identity of the principal, though, is unknown to the third party.

4211.28 **Undisclosed principal.** An undisclosed principal is a principal whose existence and identity are not known to the third party at the time of contracting. From the third party's point of view, the agent appears to be acting on their own behalf.

Legal Capacity of the Parties

4211.29 **Of the principal.** If the principal does not have legal capacity to enter a contract, the principal does not have the capacity to appoint an agent. In other words, if a principal cannot legally enter a contract directly, they cannot do so indirectly through an agent.

4211.30 **Of the agent.** To make a contract for the principal, an agent does not need contractual capacity; only the principal needs capacity to enter a contract. A minor can act as an agent for an adult, and contracts made by a minor agent are legally binding on the adult principal. These contracts with third parties would not be voidable by the adult principal even though the agent was a minor. The minor agent, however, could disaffirm the agency contract because this is a voidable contract to the minor agent. This would not, however, impact any contracts entered for the principal with third parties prior to the disaffirmance.

Example: Harris, a minor acting as an agent for Lynn, makes a contract with James. The contract is valid so long as both Lynn and James have legal capacity. It makes no difference that the agent was a minor with only limited capacity to contract for himself.

4211.31 Anyone who can act for him/herself can act through an agent.

4211.32 The purpose of the agency must be legal. Any agreements lacking a legal purpose will be found to be an illegal bargain for which the courts will not adjust equities between the parties to the agreement.

Agency Coupled with an Interest

4211.33 An agency coupled with an interest is an agency relationship where the agent has an interest in the subject matter of the agency. The subject matter is a property interest or a security interest. The principal acting alone cannot terminate the agency. Death, insanity, or bankruptcy of the principal does not terminate the agency. This relationship is sometimes called an "agency power coupled with an interest" or an "agency coupled with security."

Example: Kevin loaned $5,000 to Brian, and the debt has not yet been repaid. Brian appoints Kevin as an agent to negotiate the sale of Brian's property, with Kevin receiving a part of the sale proceeds to repay the loan. This is an agency coupled with an interest.

4212 Authority of Agents and Principals

Authority of the Agent to Act for the Principal

4212.01 The **authority**, or power, of an agent is the capacity to change the legal status of the principal by dealing with third parties.

4212.02 The authority of the agent is determined by the principal and can come only from the principal. Authority comes from the consent of the principal.

- **a.** The burden of proving the agent's authority rests with the third party who deals with the agent. If authority cannot be proved, the purported principal is not liable on the contract.
- **b.** The agent cannot create their own authority.
- **c.** A third party who deals with an agent, knowing the agent exceeds their authority, does so at their own peril and will not generally be able to hold the principal liable for the agent's unauthorized act.

4212.03 **Express authority.** Authority that is stated in spoken or written words by the principal.

Example: David owns a fruit and vegetable market. He tells Jennifer to enter a contract with Acme Produce Wholesalers to purchase 10 cases of apples. Jennifer, as agent, has express authority to make this purchase.

4212.04 **Implied authority.** The authority that is commonly and customarily needed to conduct the purpose of the agency. Implied authority is needed to fill in the gaps to carry out the agent's express authority. It cannot come from words or conduct of the agent. It can vary from one location to another. It can vary among different types of businesses.

Example: Brian owns a clothing store. He hires Erin and gives her the authority to manage the store. Erin enters a contract with ABC Clothing Corporation in order to obtain clothing to sell in the store. Even though Erin did not have express authority to enter the contract with ABC, she would have implied authority to enter this contract since it is necessary to fulfill the purpose of the agency.

4212.05 **Incidental authority.** Same as implied authority.

4212.06 **Actual authority.** The combination of express and implied authority.

4212.07 **Customary authority.** The authority that comes from the customs of that type of business.

4212.08 **Apparent authority.** Apparent authority, or appearance of authority, comes from the words or actions of the principal that lead a third party to reasonably believe and act upon the belief that actual authority exists in the purported agent. Belief and reliance are shown when the third party makes a contract with the purported agent. Apparent authority is determined from the view of the third party dealing with the purported agent. The words or actions must come from the principal, not the purported agent, in order to create apparent authority.

a. **Example:** Andrea, an outside salesperson for Mamou Corporation, called on customers, sold merchandise, delivered merchandise, and collected receivables. After being fired, Andrea collected some of the receivables from existing customers and disappeared. The existing customers will not have to pay Mamou again. The principal, Mamou, created the situation by allowing Andrea to collect the receivables previously. From the customers' point of view, Andrea had apparent authority to collect the balances due. The firing terminated actual authority, but the principal, Mamou, had led the customers to believe and act upon the belief that Andrea had actual authority. These existing customers should be informed of the firing in order to terminate the apparent authority.

b. The following factors are sometimes considered in determining whether apparent authority exists:

(1) The third party's knowledge of the agent's actual authority and limitations

(2) The customs in that type of business

(3) The principal's prior approval of similar activities by the agent

4212.09 **Ostensible authority.** Another term for apparent authority.

4212.10 **Power to appoint subagents.** As a general rule, an agent *cannot* appoint subagents in order to delegate the agent's duties and obligations. This is because the principal selects the agent based on personal qualifications. If the duties of the agent are purely ministerial, mechanical, or routine, an exception is allowed and the agent may appoint a subagent. If the duties require skill, discretion, or judgment, no subagent may be appointed unless the principal gives permission.

4212.11 **Financial powers.** An agent who sells goods for cash, and has possession of the goods, has the authority to collect the cash. The agent has no implied authority to accept credit in place of cash. Payment to an agent lacking authority to accept the payment does not discharge the debt. The third party would still be required to make payment to the principal.

4212.12 **Termination.** The agent's actual authority ceases when the agency is terminated; however, the agent still has apparent authority from the viewpoint of third parties with whom the agent has dealt. These third parties must be given actual notice of the termination to end the apparent authority. For those third parties who have not dealt with the agent, constructive notice is adequate to end the apparent authority. Publishing the termination in a newspaper having general circulation is adequate constructive notification as to those third parties.

Termination of the Agency

4212.13 **Revocation by the principal.** The principal acting alone can revoke the authority of the agent. This is because an agency is a consensual relationship requiring the consent of both parties.

- **a.** If the relationship is an agency coupled with an interest, the principal cannot revoke the agency.
- **b.** The principal can still be liable on the agency relationship because the agent may still have apparent authority from the view of third parties with whom the agent has previously dealt. These third parties should be given actual notice of the dismissal of the agent. This notice would eliminate the lingering apparent authority. The notice can be given in person, by letter, or by phone.
- **c.** If the revocation is contrary to the agency contract, the principal could be liable for breach of contract if the breach is not justified. This is true because, while principals have the power to terminate the agency, they may not have the legal right to do so.

4212.14 **Renunciation by the agent.** Renunciation takes place when the agent acting alone withdraws from the agency relationship.

- **a.** If the renunciation is contrary to the agency contract, the agent could be liable for the breach of contract if the breach is not justified. Like the principal, the agent also has the power to terminate the agency but may not have the legal right to do so.
- **b.** **Example:** Dave employs Jennifer as his agent under a three-year agency agreement. After six months, Jennifer withdraws as Dave's agent. Jennifer has the power to terminate the agency in this way but will be liable to Dave for breach of contract.

4212.15 **Mutual agreement of both principal and agent.** If the principal and the agent mutually agree to end the agency relationship, it ends.

4212.16 **Accomplishment of the purpose of the agency.** When the purpose of the agency is done, the agency relationship terminates.

Example: The legal case given to the lawyer is settled and paid. The lawyer, a special agent, has accomplished the purpose of the agency, and the agency relationship is terminated.

4212.17 **Time period ends.** If the principal and agent have agreed that the agency relationship will end after an express period of time, the lapse of that time will terminate the agency relationship.

4212.18 Operation of law. Operation of law means automatically without any action needed by the parties. All authority of the agent is terminated, even apparent authority, when the termination is by operation of law. An agency relationship is terminated by operation of law without notice being required in the following circumstances:

a. Death of the principal or agent. It is not necessary that the other party have knowledge of the death.

b. Insanity of the principal or agent. It is not necessary that the other party have knowledge of the insanity.

c. Bankruptcy of the principal. It is not necessary that the other party have knowledge of the bankruptcy. The agency relationship is not terminated if the agent becomes bankrupt.

d. Impossibility of performance. If the purpose of the agency becomes objectively impossible to perform, the agency terminates by operation of law.

Example: Caitlin is acting as agent to sell Erin's office building. If the building is destroyed by fire, the purpose of the agency becomes objectively impossible to perform. The agency therefore terminates by operation of law.

e. The performance of the agency becomes illegal.

Example: Brian employs Kevin as his agent to sell fireworks to third parties. If the state subsequently passes a statute making the sale of fireworks illegal, the agency would terminate by operation of law.

4212.19 Notice to third parties

a. Generally, the principal should give personal notice of termination of the agency to any third party who has dealt with the agent. This would eliminate any problems with the principal being bound to contracts entered by the former agent under the doctrine of apparent authority.

b. Published notice of termination of the agency is generally sufficient notice to any third parties who have not dealt with the agent previously.

c. Acts of the agent after a termination by operation of law cannot bind the principal or the principal's estate based on a theory of apparent authority.

4213 Duties and Liabilities of Agents and Principals

Agent's Duties and Obligations

4213.01 Agent's duties and obligations to the principal. This is a fiduciary relationship, one of trust and confidence. Some of the attributes of this fiduciary relationship are the following:

a. Loyalty. Undivided loyalty to the principal with no conflict with the agent's personal interests. The agent should not disclose confidential information to anyone except the principal. The agent should not act for two principals (dual agency) unless both principals know and agree. The agent may not make a secret profit on the subject matter of the agency. The agent cannot engage in self-dealing.

(1) An agent who breaches the fiduciary duty of loyalty loses any compensation, fee, or commission that would have been due to the agent.

(2) If the principal finds the agent has been self-dealing, the transaction is voidable at the principal's option.

Example: The principal employs an agent to purchase a specified piece of land. If the agent instead purchases the land for herself, this is a breach of the duty of loyalty to the principal.

b. **Obedience.** The agent should follow instructions unless they are criminal or illegal. If the agent fails to follow instructions, the agent is personally liable for any loss incurred by the disobedience. If there are no instructions, the agent is not disobedient if the agent uses judgment in discretionary or emergency situations.

   Example: The principal tells the agent not to give goods to Kevin until Kevin pays. Kevin promises the agent that he will pay in three days if the agent gives him the goods now. If the agent hands over the goods and Kevin does not pay, the agent is liable to the principal for the contract price.

c. **Accounting.** The agent must keep records for examination by the principal. The agent must not commingle the principal's property with his own. The agent is legally liable if commingling causes a loss.

   If the agent uses the principal's funds for their own purpose, the principal can sue the agent for the return of the funds. If the agent has purchased property with the funds, the principal can generally elect to take the property even if it is of greater value.

   Example: An agent uses the principal's funds ($500) to purchase a painting. The principal can recover either the $500 or the painting, even if the painting has appreciated in value.

d. **Due care.** The agent must use reasonable care and not be negligent in carrying out the agency. Reasonable care is that care a reasonably prudent person would use in like or similar circumstances. The agent may be liable to the principal if the agent is negligent in carrying out the agency.

e. **Give notice of information.** The agent must transmit important information to the principal. Failure to do this could be costly to the principal because notice to the agent is legally equivalent to notice to the principal. The agent can be held liable for any damages that result from the failure to give notice.

f. **Indemnification.** The agent must indemnify the principal if the principal pays damages in a legal action for the wrongful acts of the agent.

g. **Competition.** The agent must not compete with the business activity of the principal.

h. **Termination.** After the agency relationship is terminated, the former agent cannot continue to act as the principal's agent. The duty not to disclose confidential information regarding the agency continues, however, even after the agency is terminated.

4213.02 **Agent's duties and obligations to employees.** Unless they are also agents, employees do not act in a fiduciary relationship to their employer.

Principal's Duties and Obligations

4213.03 The principal's duties and obligations to the agent are not fiduciary. The agent owes a fiduciary duty to the principal, but the principal does not owe a fiduciary duty to the agent.

4213.04 These are the duties and obligations that the principal owes to the agent:

a. **Compensation.** The principal generally owes to the agent the duty of compensation. If the amount is expressly mentioned in the contract, that will be the amount. If no amount is expressly mentioned, it will be the reasonable amount as determined by the court. The compensation may be on a contingent fee basis. A person may act as a gratuitous agent, but the normal assumption is that a person expects to be compensated for activities done for the benefit of some other person.

b. **Reimbursement.** The principal must reimburse the agent if the agent spends their own funds to carry out the agency.

Example: Erin, acting as agent for Jennifer, delivers goods to a customer of Jennifer. The customer refuses to accept the goods and Erin incurs costs to store the goods. Erin is entitled to reimbursement from Jennifer for the storage costs.

c. **Indemnity.** The principal must indemnify the agent if the agent suffers expenses from a legal action resulting from carrying out the agency.

Example: Erin, acting as agent for Jennifer, her undisclosed principal, enters into a contract with Emily. The contract is breached and Emily sues Erin, collecting a judgment of $5,000. Jennifer must indemnify Erin for the $5,000 loss.

d. **Contractual.** The principal must perform all the terms of the agency contract or be legally liable for breach of contract.

e. **Warnings.** The principal must warn the agent of any dangers and unreasonable risks involved in the employment.

Third Party's Duties and Obligations

4213.05 The third party is liable for all the duties and obligations that arise from the contract.

Agent's Rights

4213.06 **Agent's rights against the principal.** The principal's duties and obligations are the rights of the agent. The agent has the following rights:

a. **Have the principal perform the agency contract.** If the principal breaches this contract, the agent can sue the principal.

b. **Compensation.** Unless it is agreed otherwise, it is assumed that the principal should compensate the agent for the work. The amount will be the contract amount. If no amount is given in the contract, it will be the reasonable value of the services.

c. **Reimbursement.** If the agent expends their own funds in carrying out the agency, the principal must repay the agent.

d. **Indemnity.** If the agent pays damages from a legal action based on carrying out the agency, the principal must indemnify the agent.

4213.07 **Agent's rights against the third party.** For the usual situation involving a disclosed principal and a contract, the agent has no rights against the third party because the agent is not a party to the contract. If the agent is liable on the contract due to the fact the principal is undisclosed or partially disclosed, the agent has whatever rights come from the contract. The presence or absence of the agency relationship does not affect the rights of the agent on the contract.

Principal's Rights

4213.08 **Principal's rights against the agent.** The principal has the following rights:

- **a.** Performance of the agency contract by the agent.
- **b.** Indemnification from the agent/employee if obligated to pay damages for the torts of the agent/employee in a suit by a third party based upon the doctrine of *respondeat superior.*

  Example: Agent/employee negligently operates the employer's delivery truck while working and injures a pedestrian. Under the doctrine of *respondeat superior,* the injured pedestrian sues the employer and collects $25,000. The employee must indemnify the employer for the amount of $25,000.
- **c.** In addition to the rights that the principal has by virtue of the agency relationship, the principal also has the right to expect the agent to act as a fiduciary. This fiduciary relationship requires the agent to place the interests of the principal above their own interests. The principal has the right to sue the agent for breach of this fiduciary duty.

4213.09 The principal has the right to expect performance of contracts made with third parties regardless of whether the contract was made personally or by an agent. If the third party has committed a tort against the principal, the principal has a right to sue for damages.

4213.10 The principal can enforce their rights in the following ways:

- **a.** By suing for the legal remedy of damages
- **b.** By seeking an equitable remedy, such as an injunction, specific performance, rescission of the contract, or an accounting
- **c.** By revoking the agency. This would involve discharging the agent.

Third Party's Rights

4213.11 **Third party's rights against the principal**

- **a.** **For contracts.** The third party has the rights that arise from the contract. If the principal breaches the contract, the third party can sue the principal for breach of contract.
- **b.** **For torts of the agent/employee.** The third party can sue the principal for torts of the agent if the agent/employee was acting in the scope and course of the agency when the tort happened. This is called the doctrine of *respondeat superior*.

4213.12 **Third party's rights against the agent**

- **a.** **For contracts.** If the principal was undisclosed or partially disclosed, the agent can be sued on the contract. If the principal was disclosed at the time of making the contract, the agent cannot be sued on the contract.
- **b.** **For torts of the agent.** The agent, like everyone else, is responsible for his/her own torts. The third party can sue the agent for the agent's torts against the third party.

Agent's Liability

4213.13 Agent's liability on contracts

a. As a general rule, the agent is *not* personally liable on contracts the agent makes for the principal.

b. **With a disclosed principal.** When the third party knows that the agent is acting as an agent and also knows the identity of the principal, the agent is not liable on the contract. This is the usual and most common situation.

c. **With a partially disclosed principal.** A partially disclosed principal exists when the third party knows the agent is acting for a principal, but the third party does not know the principal's identity. The agent is liable on the contract. Once the identity of the principal is discovered, the third party could also sue the principal but cannot recover from both.

d. **With an undisclosed principal.** An undisclosed principal exists when the third party, at the time of contracting, does not know the person is acting as an agent. The agent is liable on the contract. Once discovered, the third party can also sue the principal but cannot recover from both.

e. **With a nonexistent principal.** The agent is personally liable on the contract if the agent contracts with a third person by representing that the agent acts for a fictitious or nonexistent principal. The agent would be breaching the implied warranty of authority that is made to the third party.

f. The agent is personally liable to the third party on a contract in the following instances:

(1) The agent makes the contract in her own name. The principal would be either undisclosed or partially disclosed.

(2) The agent guarantees the performance of the principal, and the principal fails to perform.

(3) The agent contracts for a nonexistent principal and makes no guarantees.

(4) The agent acts without authorization from the principal in making the contract.

g. The agent is *not* liable on a contract in the following instances:

(1) The agent contracts for a disclosed principal.

(2) The principal ratifies an unauthorized contract made by the agent for the principal. In this case, the action of the agent is treated as if it were authorized from the beginning.

(3) The third party elects to hold the newly discovered principal liable on a contract made by the agent for an undisclosed or partially disclosed principal.

4213.14 Agent's liability for torts. An agent/employee, like any individual, is liable for his/her own torts. This liability exists even though the agent/employee is working for the principal when the tort occurs. If the injured third party sues the principal under the doctrine of *respondeat superior* and collects, the agent/employee has the legal duty to indemnify the principal since this is a breach of the duty to carry out the agency using due care.

4213.15 Agent's liability for crimes. The agent/employee, like any individual, is liable for his/her crimes. The fact that the agent/employee is working for a principal when the crime is committed is no defense for committing the crime.

4213.16 Agent's liability on negotiable instruments. An agent will be liable on a negotiable instrument if the agent signs his/her own name without indicating the existence and the identity of the principal.

a. If the act is authorized, the agent can expect reimbursement from the principal for the amount paid on the negotiable instrument.

b. To avoid liability on the instrument, the agent must indicate that the signing is in a representative capacity (as an agent for another party).

Example: The agent is not liable on the instrument if agent Ann Addley signs for SAS Corporation like this:

SAS Corporation
by Ann Addley, Agent

c. The agent will also be liable on a negotiable instrument if the agent signs the principal's name without authority. This is forgery.

Principal's Liability

4213.17 Principal's liability for contracts

a. When the agent had actual (express or implied) authority, the principal is liable on the contract.

b. When the agent did not have authority but the act was later ratified by the principal, the principal is liable on the contract.

c. When the purported agent had apparent authority to make the contract, the principal is liable on the contract.

d. The principal is not liable even if the purported agent represents that she acts for the principal if the act is unauthorized.

e. **Settlement before discovery.** If an undisclosed principal settles with the agent after the contract is made, after the goods are delivered, and before discovery by the third party, the principal is not liable on the contract. The agent would be liable.

f. **Settlement after discovery.** If an undisclosed principal settles with the agent after the contract is made, after the goods are delivered, and after discovery by the third party, the principal is liable on the contract.

g. **Notice to agent.** Notice to the agent or knowledge obtained by the agent within the scope of the agency binds the principal. The principal need not have actual knowledge to be held liable.

h. The principal is directly liable on all contracts he makes with other persons.

i. The principal is vicariously liable on contracts made by authorized acts of agents.

j. The principal can use the usual defenses to deny liability on a contract. The principal cannot use the defenses that are personal to the agent.

4213.18 Principal's liability for torts of the agent/employee. The principal is liable for torts of the agent if the agent was acting in the scope of and in the course of the agency when the tort happened. This vicarious liability is called the doctrine of *respondeat superior*. The term "vicarious" means a substitute. The principal is liable as a substitute for the agent. The principal is liable whether the tort was authorized or unauthorized. The principal is liable whether the tort was defined as intentional, negligence, or liability without fault.

a. The trend is to expand the doctrine of *respondeat superior* to make the principal legally liable in more circumstances.

b. If the agent/employee is not acting for the principal, the agent is on a detour or on a "frolic of their own" and is the only person liable for the tort.

4213.19 **Principal's liability for torts of an independent contractor.** As a general rule, the principal is not legally liable for the torts of an independent contractor. Only the independent contractor is liable for the torts. The exceptions to this rule are as follows:

a. **Work that is inherently dangerous.** It would be contrary to public policy to allow a person to avoid liability by hiring an independent contractor to do inherently dangerous work.

b. **Work that is illegal.** A principal cannot avoid liability by hiring an independent contractor to perform illegal work that will benefit the principal.

c. **Work that is inseparable from the principal's operation.** If the work is so integrated into the business operation that it cannot be delegated, the principal is liable.

Example: A hotel could not hire an independent contractor to operate the elevator system because operation of the elevator is essential to a multistory hotel's operation. If the independent contractor committed a tort while operating the elevator, the hotel, in addition to the independent contractor, would be liable.

d. **Work that cannot be delegated.** Some duties imposed by law are nondelegable.

4213.20 **Principal's liability for crimes of the agent.** The principal is not liable for the crimes of the agent unless the principal actually participated in the crime.

Example: Jim, acting as an agent, was making a delivery for his principal, Susan. While driving the truck he was given a ticket for speeding and reckless driving. Speeding and reckless driving are crimes. Susan, the principal, is not liable for the crimes of speeding and reckless driving.

4213.21 **Principal's liability on negotiable instruments.** A principal will be liable on a negotiable instrument if either of the following is true:

a. An agent with authority signs the principal's name.

b. The principal signs his own name.

Third Party's Liability

4213.22 The third party is liable on contracts that they make. The agency relationship on the other end of the contract does not affect the liability of the third party. The third party is liable even if the principal is undisclosed or partially disclosed.

4220 Contracts

4221 Formation

4221.01 A *contract* is a legally enforceable agreement.

Classifications of Contracts

4221.02 **Express contract:** The parties manifest their agreement by spoken or written words.

4221.03 **Implied contract:** Implied in fact. The agreement is manifest, not by direct words, but from the conduct of the parties.

4221.04 **Quasi contract:** Implied in law. One party is unjustly enriched at the expense of the other party such that the court will impose an obligation on the enriched party to pay the other party. No quasi contract will be imposed if there is an express or implied contract existing between the parties. The court implies a contractual obligation without regard to the agreement of the parties in order to prevent the unjust enrichment from occurring.

4221.05 **Formal contract:** Under seal. Consideration is conclusively presumed. A notary public's imprint on a document is not a seal.

4221.06 **Informal contract:** Without a seal. Most contracts are informal and do not require a seal to be legally enforceable.

4221.07 **Divisible contract:** Promises that are not dependent on each other. Partial performance of the contract is allowed.

4221.08 **Indivisible contract:** Interdependent promises that cannot be separated.

4221.09 **Unilateral contract:** A promise in exchange for an act.

4221.10 **Bilateral contract:** Promise in exchange for a promise.

4221.11 **Executory contract:** Something remains to be completed on the contract.

4221.12 **Executed contract:** All parties to the contract have done all that they are obligated to do.

4221.13 **Unenforceable contract:** A contract that will not be enforced by the court. Valid when made but made unenforceable by some later event, such as the running of the statute of limitations or discharge of the contract in bankruptcy.

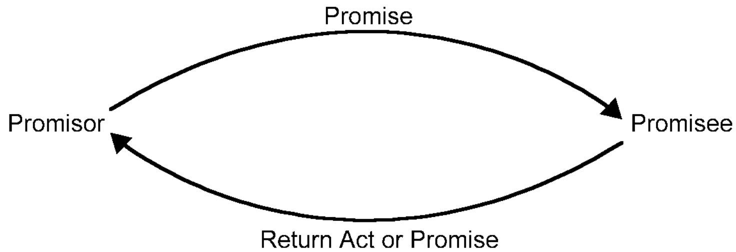
4221.14 **Valid contract:** Binding and enforceable.

4221.15 **Void contract:** Never had legal effect because of the lack of an essential element.

4221.16 **Voidable contract:** Valid until one party exercises a right to avoid the contract.

Parties to a Contract

4221.17 Parties to a contract may be diagrammed as follows:



Laws Governing Contracts

4221.18 **Laws governing contracts for sale of goods** (personal property): Uniform Commercial Code (UCC). If no specific UCC rule applies, common law applies.

4221.19 **Laws governing contracts for sale of real property:** Common law rules apply.

4221.20 **Laws governing contracts for services** (employment): Common law rules apply.

Elements of a Contract

4221.21 There are four **elements** necessary to have a valid contract:

1. Agreement: Manifestation of mutual assent
2. Consideration
3. Legal purpose
4. Competent parties

4221.22 An *agreement* is a mutual understanding between two or more persons.

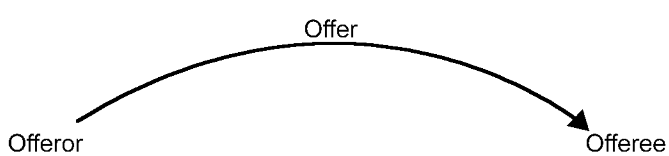
4221.23 There must be a manifestation of mutual assent for the parties to be legally obligated on the contract.

4221.24 Objective standard is used to determine agreement. This means what persons show by their conduct, not necessarily what is thought.

4221.25 Normally, an agreement is reached by an offer and an acceptance of that offer.

4221.26 An *offer* is a promise to do or refrain from doing something in the future provided the other party complies with the stated conditions.

4221.27 Parties to an offer may be diagrammed as follows:



4221.28 The offer is always a promise.

4221.29 To have a valid offer, the following must be true:

a. **There must be contractual intent.** Use the reasonable person objective standard. Ask, "Would a reasonable person based on the circumstances believe that an offer had been made?" An offer is not any of the following:

(1) A social invitation. "If you promise to come over to my house tonight, I promise to cook you a steak dinner." This creates a social, not a legal, obligation.

(2) A statement made in obvious jest. "I will give a million dollars to anyone who will tell me the name of that song."

(3) A statement made in anger, rage, or excitement. "I will give a million dollars to anyone who tells me the name of the person who stole that bike from me."

(4) An invitation to negotiate further

b. **The offer must be definite and have a certainty of terms.** Courts cannot enforce what cannot be determined. It need not be with absolute certainty but must be capable of determination with reasonable certainty.

(1) Usually need time of performance, price, what is to be done, and subject matter of the contract identified.

(2) Output contracts are OK. An *output contract* promises to sell all of a person's production over a set period of time.

(3) Requirements contracts are OK. A *requirements contract* promises to buy all of a person's requirements for the product over a set period of time.

(4) Failure to state a specific dollar price is OK, if the price can be objectively determined.

Example: I promise to sell you 1,000 bushels of corn at the market price next Thursday.

c. **The offer must be communicated to the offeree.** It may be to an individual or to a group.

4221.30 **Advertisements:** Attempts to solicit an offer from the reader. Advertisements are not definite enough to be an offer, even if it contains a stated price.

4221.31 **Quote:** Invitation to make an offer—not an offer.

4221.32 **Bid:** An offer.

4221.33 **Preliminary negotiations:** Dickering before a final contract—not an offer.

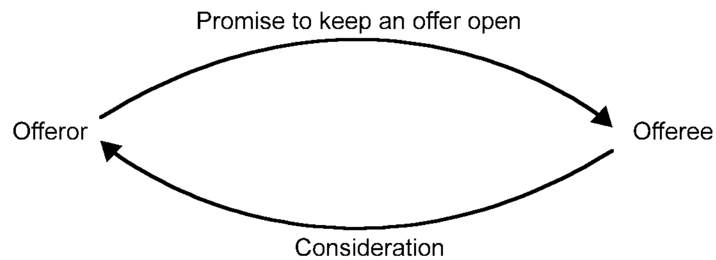
4221.34 An offer may be withdrawn (revoked) by notifying the offeree any time before acceptance.

4221.35 Revocation of an offer by the offeror is effective when received by the offeree.

4221.36 Rejection of an offer by the offeree is effective when received by the offeror.

4221.37 An offer may not be assigned to anyone else.

4221.38 **Option contract:** A contract entered to keep an offer open; the offer cannot be withdrawn without breach of contract during the agreed-upon time period.



4221.39 An offer may be terminated by the following:

- **a.** Expiration of the time specified in the offer or a reasonable time if no time is mentioned
- **b.** Revocation received by the offeree before acceptance
- **c.** Rejection by the offeree (a counteroffer is a rejection combined with a new offer to the original offeror)
- **d.** Death of the offeror or offeree
- **e.** Insanity of the offeror or offeree
- **f.** Destruction of the subject matter relating to the offer without the fault of either party
- **g.** Intervening illegality—subsequent legislation making the offer or the resulting contract illegal (e.g., an offer to sell bourbon just before prohibition became effective)

4221.40 **Irrevocable offers** are exceptions to the general rule that offers are revocable. These are some examples of irrevocable offers:

- **a.** Option contract—made irrevocable by a contract between the parties in which the offeror agrees to keep the offer open in return for some consideration from the offeree.
- **b.** Unilateral contract when the offeree has begun substantially to perform the contract. Revocation would be unfair to the party who has begun performance.
- **c.** Stated time of a written offer signed by a merchant even though there is no return consideration received in exchange for the promise. (UCC 2-205)

4221.41 Acceptance is assent of the offeree to the terms of the offer.

4221.42 Offer + Acceptance = Mutual assent

4221.43 The acceptance must conform to the terms of the offer. An acceptance that adds terms to the original offer is a counteroffer. See UCC 2-207 for an exception for nonmaterial terms for contracts between merchants.

4221.44 The acceptance must be communicated to the offeror. Acceptance is effective when dispatched if an authorized method is used even if it is not received by the offeror.

- **a.** Dispatch means to send.
- **b.** If the method of acceptance is specified, that is the only authorized method.
- **c.** If the method of acceptance is not specified, the following would be authorized methods:
  - (1) Same as the offeror used to convey the offer

(2) Customary method used in this type of transaction

(3) Prior method used between the parties in question

4221.45 The offeree must have knowledge of the offer for there to be an acceptance. You cannot accept what you do not know about. (This comes up in reward cases.)

4221.46 Silence does not constitute acceptance unless justified by prior dealings, or the parties agree that silence will operate as an acceptance.

4221.47 Acceptance may be by making a return promise (bilateral contract) or completion of an act (unilateral contract).

4221.48 To create a contract, mutual assent (agreement) must be given. Real assent is lacking if a party is induced to contract by mistake, fraud, duress, or undue influence, in which case the wronged party can avoid the contract. A contract obtained by mistake, fraud, duress, or undue influence is voidable.

Fraud in the Inducement

4221.49 **Fraud in the inducement** is a false representation of a material fact intentionally made, justifiably relied upon, and resulting in injury.

4221.50 **Definitions**

- **a.** **Fact:** It is not an opinion or a prediction of what will happen in the future. An opinion by an expert may be considered a fact. A fact is something that can reasonably be subject to exact knowledge.
- **b.** **Material:** It must be related to something of substance and must be important.
- **c.** **Intentionally:** Known by the speaker to be false.
- **d.** **Justifiably:** No better information available. If the party knows the statement is false, or could easily and should reasonably have checked the statement, the reliance is not justifiable.
- **e.** **Injury:** Some damages result from the wrong.

4221.51 Fraud may be an act, an omission, a concealment, or a nondisclosure.

4221.52 Silence alone is not fraud unless there is a duty to speak based on the relationship between the parties.

4221.53 If the misrepresentation is innocent and not made with the intent to deceive, the injured party may rescind the contract, but cannot obtain damages for the tort of deceit. Deceit is the tort equivalent to *fraud in the inducement* for contracts.

Fraud in the Execution

4221.54 **Fraud in the execution** results from the substitution of one document for another. The contract so executed is void because there is no consent to contract. The person signing either does not intend the signature to show agreement to a contract or is misled, through no negligence of their own, as to the contents of the writing.

Duress

4221.55 **Duress** is a wrongful act that compels contractual agreement through fear. Duress is subjective (what a person thinks), not objective (what a person shows). Age, sex, experience, intelligence, and relation of the parties must be considered.

4221.56 The acts leading to duress need not be illegal, although they often are. The threats can be against the individual, someone closely related to the individual, or their property.

- **a.** Threat of a civil suit is not duress. A person has the right to file a civil suit.
- **b.** Threat of criminal suit may be duress.
- **c.** Mere argument, advice, persuasion, or annoyance is not duress.
- **d.** Duress makes the contract voidable.

Undue Influence

4221.57 **Undue influence** is unlawful control exercised by the dominant party, which is a substitute for the free will of the dependent party.

4221.58 Undue influence is similar to duress but is generally applied to persons in a close confidential relationship, such as the following:

- **a.** Husband and wife
- **b.** Parent and child
- **c.** Guardian and ward
- **d.** Trustee and beneficiary

4221.59 Courts are not strict in determining what is a confidential relationship.

4221.60 If there is a transaction where the dominant party has gained at the expense of the dependent party, the undue influence is presumed, and the burden of proof is upon the dominant party to prove otherwise.

Mistakes

4221.61 **Mutual mistake.** If both parties are mistaken as to a material fact (neither at fault or both at fault equally), the contract is voidable.

Example: The parties enter a contract for the sale of a horse, both believing the horse is alive at the time. If the horse in fact has died before the agreement is entered, the contract is voidable by either party based on mutual mistake.

4221.62 **Unilateral mistake.** One party is mistaken. There is a good contract so long as the other party is not aware of the mistake and has not entered the contract to take advantage of the mistaken party.

4221.63 A mistake as to value is an ordinary risk in the normal business transaction. A contract cannot generally be avoided for a mistake in value.

4221.64 A mistake of law as to the parties’ legal rights under the contract is not grounds for rescission.

4221.65 If a person knowingly and voluntarily signs a document, the person is conclusively presumed to know its contents and assent to them. The person cannot avoid the contract for a mistake.

Unconscionable Contract

4221.66 If the court finds as a matter of law that a contract is unconscionable, it may reform the contract to serve justice (see UCC 2-302).

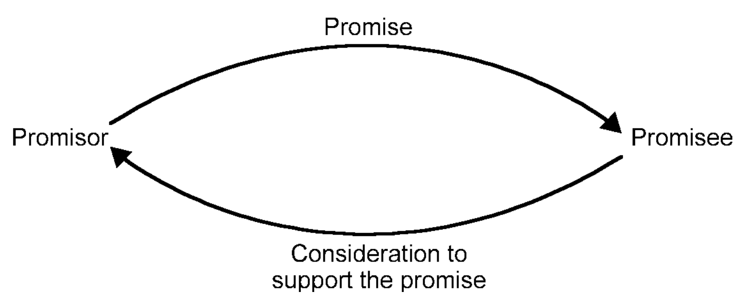
4221.67 If the parties are in unequal bargaining positions, the courts are more likely to find an unconscionable contract and will allow the party in the inferior position to avoid the obligation.

4221.68 An unconscionable contract is a contract that no rational person would enter into and no ethical person would want to impose on another person.

4222 Performance

Consideration

4222.01 **Consideration:** A bargained-for exchange in which there is legal detriment to the promisee or legal benefit to the promisor.



4222.02 Consideration is the inducement to enter the contract. Most people would not enter into a contract unless they received something in return.

4222.03 Consideration must be bargained for. It cannot have already happened. Past consideration is not valid consideration.

4222.04 A contract must be supported by consideration to be valid and enforceable. It is one of the four elements of a contract.

4222.05 Relative value differs from legally sufficient consideration. The two considerations need not be of approximately the same value. Generally, courts do not look at the adequacy of the consideration.

4222.06 Consideration applies only to executory contracts, not executed contracts. If the contract is already completed, there is no longer a question of the contract being enforceable.

4222.07 The following are not good considerations:

a. **Illusory promise:** A promise in form but not in substance.

(1) A promise to buy whatever gasoline I want for the next year. This is a promise in form but really obligates me to do nothing. I could buy nothing or I could buy 500 gallons of gasoline and still not break my promise.

(2) Output and requirement contracts are not illusory.

b. **Doing what one is already legally bound to do by previous contract or statutory duty**—for instance, paying a police officer to catch criminals. This is a preexisting duty.

c. **Past consideration**—cannot be consideration for a new contract.

d. **Moral consideration**—a person may feel morally obligated, but this does not mean legally obligated.

4222.08 Consideration may be any of the following:

a. A return promise to do something the promisee is not legally obligated to do

b. An act other than a return promise that the promisee is not legally obligated to do

c. A forbearance—promising not to do something that the promisee has a legal right to do

4222.09 **Liquidated debt:** Debt for a sum that both parties agree as to amount. Payment of a lesser sum will not discharge the balance since the debtor has a preexisting duty to pay the agreed amount. Some additional consideration is needed to support a promise to forget about collecting the remaining amount. Paying before the due date would be such additional consideration if both parties agree. This is true, since prior to this agreement the party is not legally obligated to pay early.

4222.10 **Unliquidated debt:** Amount is disputed in good faith by the parties. Payment of a sum less than the amount suggested by one of the parties discharges the obligation if the other party accepts the lesser amount as full payment.

4222.11 **Promissory estoppel**

a. A substitute for consideration

b. Three elements must exist for promissory estoppel to apply:

(1) A promise by the promisor that is reasonably expected to be relied upon by the promisee

(2) The promisee does in fact detrimentally rely on the promise.

(3) Injustice can be avoided only by enforcing the promise.

c. A promise that induces action is binding without return consideration if justice is served.

d. **Example:** A promise of a donation to a charity when the charity makes expenditures in anticipation of the donation but does not give return consideration to support the promise to donate. Promissory estoppel could be used to enforce the promise to donate to the charity even though the promise is not supported by consideration.

4222.12 **Seals.** If a document has a seal, consideration is conclusively presumed. The Uniform Commercial Code (UCC) negates the effect of seals for sale of goods contracts. A seal can be the word *seal* on the contract.

4222.13 Promises that do not require consideration under the Uniform Commercial Code (UCC):

a. A claim for breach of contract for sale of goods can be discharged without consideration if a written waiver is signed and delivered.

b. A written offer (promise) by a merchant to buy or sell goods cannot be withdrawn for the time stated, even though the offeree has not given return consideration to be binding.

4222.14 A promise that does not require consideration under the common law:

A renewed promise to pay a debt that cannot be enforced, because of the statute of limitations, needs no new consideration.

Illegal Bargains

4222.15 An agreement whose formation or performance is a tort, a crime, or is opposed to public policy constitutes an illegal bargain.

4222.16 The court will not enforce an illegal bargain, generally leaving the parties where the court finds them. This means the court will not adjust the equities between the parties. The courts will sometimes grant relief to the following persons even though they are involved in an illegal bargain:

a. A party that the violated law intended to protect. States have laws that require all physicians to be licensed by the state. An unlicensed physician who contracts with a patient has violated the licensing statute making the agreement an illegal bargain. The courts will help the patient, but not the physician. The licensing statute was enacted to protect patients from unlicensed physicians.

b. A party that is not in a good bargaining position when making the agreement. This party is said to be not equally at fault (not *in pari delecto*). Courts will sometimes grant relief to this type of party.

c. A party who seeks to back out of an illegal bargain before execution

d. A party to an agreement when part is legal and part is illegal. Sometimes the courts will grant relief if the obligations are severable. This means the courts will separate the agreement to make an enforceable portion and an unenforceable illegal bargain.

4222.17 **Violation of statutes**

a. **Criminal statutes:** The bargain is always illegal and unenforceable. The following are examples:

(1) Bribing a government employee to get a contract

(2) An agreement to commit any statutory crime, such as hiring a hit man to kill someone

b. **Licensing statutes:** Illegal and unenforceable only if licensing is for regulatory purposes.

(1) **Regulatory:** The purpose is to protect the public against unqualified persons, for instance, a lawyer, physician, CPA, or real estate broker. The professional could not recover on the agreement if they were not properly licensed.

(2) **Revenue-producing:** The purpose is to raise money, for instance, a salesperson’s license or driver’s license. Failure to have a license required by a revenue-producing

statute does not make the contract illegal. Either party could recover on the contract.

c. **Wagering or gambling agreements:** The agreement is not enforceable. A gambling agreement results when the parties bet on the outcome of an uncertain event in which the parties have no interest other than the bet.

d. **Usury:** Charging an interest rate in excess of the maximum allowed by statute for the loan of money.

(1) Remedy for violation:

(a) Lender collects principal but not interest in the majority of states.

(b) Lender collects principal and interest up to the lawful rate.

(c) Lender loses both principal and interest.

(2) The following are permissible and are not usury violations:

(a) Collecting a legal maximum interest in advance

(b) Adding a reasonable service fee to cover incidental cost of inspection, service, and recording

(c) Having a credit price and a cash price for the sale of goods

(3) Statutory exceptions allowing higher interest rates exist for the following:

(a) Pawnshops

(b) Small loan companies

(c) Credit unions

(4) Usury does not apply to time payment differential on the sale of goods, only to lending money.

(5) Many states have enacted consumer credit laws to make consumer credit sales, revolving charge accounts, and interest on credit card sales subject to maximum percentages of interest. In effect, the loan of money and these consumer transactions are both subject to a maximum interest rate.

4222.18 Bargains contrary to public policy are also illegal and unenforceable.

a. **Restraint of trade**

(1) Society looks with disfavor on any agreement that unnecessarily restrains a person from exercising their trade, business, or profession.

(2) Contracts in total restraint of trade are always illegal. A contract in total restraint of trade has as its prime purpose the establishment of a monopoly through price fixing, division of sales territories, and limitations on production.

(3) A contract in partial restraint of trade, if the restraint is secondary to the main purpose of the contract (ancillary in nature).

(a) It is enforceable if the following are true:

i. The restraint is necessary to protect the purchaser, the remaining members of the business, or the employer.

ii. The restraint is reasonable as to time and geographic area.

iii. The restraint does not place an undue burden on the promisor.

iv. It occurs in the sale of a business or profession, the sale of property, or the termination of employment.

(b) This type of agreement is referred to as a covenant not to compete.

(4) Courts will enforce the remainder of the contract without the restraint of trade clause.

b. Obstructing the administration of justice, such as bribing a judge or juror

c. Corrupting public officials

d. **Exculpatory clause:** Provision of a contract which relieves a person of liability for his own negligence. Attempts to do this are sometimes seen on signs in parking lots, such as "Not responsible for damage done to your car." Courts do not enforce exculpatory clauses that are determined to be contrary to public policy.

e. Unduly influencing legislative or executive action

Contractual Capacity

4222.19 Every party to a contract is presumed to have contractual capacity until shown otherwise.

4222.20 **Minors**

a. A minor's contract is voidable at their option, but the other party to the contract may not avoid the contract.

b. Generally, the age of majority, when the individual is no longer a minor, is the age of 18.

c. Contracts by a minor for necessities:

(1) A minor will still have to pay the reasonable value of necessities. This may or may not be the same as the contract price. This is a quasi-contractual obligation imposed by the courts to prevent unjust enrichment.

(2) What is a necessity is a question of fact. Necessities have always been considered food, clothing, lodging, and medical services not supplied by a parent. Items for health, education, and transportation may be necessities in some cases.

(3) In order to recover, the burden of proof as to what is a necessity rests with the adult seller.

d. **Disaffirmance**—getting out of the contract

(1) A minor may disaffirm contracts while still a minor and for a reasonable time after reaching majority.

(2) It may be an express or an implied disaffirmance.

(3) If a minor has the goods, the minor must return them to the seller to disaffirm a contract for the sale of the goods. The goods can be in any condition. The right to disaffirm is not conditioned on being able to return the goods.

(4) A disaffirmance of a conveyance of land can only be done after the minor reaches majority; however, the minor who sold land and disaffirmed the contract can retake the land before reaching the age of majority.

(5) A minor who has sold goods may not be able to regain the goods even if they disaffirm. The Uniform Commercial Code (UCC) allows a person with a voidable title to transfer good title to a good-faith purchaser for value. If the adult has sold the

goods to someone else in good faith and for value, the minor cannot get them back. The minor can get the money equivalent to the value of the goods.

(6) A minor is liable for torts if the torts are independent of the contract. Misrepresentation of age is a good example of a tort that precedes, and is independent of, the contract of sale.

(7) Contracts a minor may not be able to disaffirm include the following (it varies by state):

(a) Educational loans

(b) Court-approved contract (court has already checked to see that the contract is fair)

(c) Enlistment contract

(d) Insurance contract

(e) Medical care

(f) Bank account

(g) Stock transfer

(h) Business contract

(i) Marriage contract

e. **Ratification**

(1) A person is liable on a contract made during their minority if they ratify the contract. A minor can ratify a contract only after reaching the age of majority.

(2) Ratification may be expressed in words or implied by actions.

(3) Retention of goods for an unreasonable time after reaching majority age can amount to ratification of the contract.

f. A parent is not liable for the minor’s contracts unless the minor is acting as the parent’s agent.

g. A minor’s contracts are voidable, not void.

4222.21 Insane persons

a. A mentally incompetent person may avoid liability on contracts. Test: “Is the person unable to understand the effect and nature of the act?”

b. It is not necessary to be adjudicated insane to be mentally incompetent.

c. If a person is adjudicated insane, his agreements are void. If a person can show that he is mentally incompetent without prior adjudication of insanity, his contracts are voidable.

4222.22 Intoxicated persons

a. A contract made by a person so intoxicated so as not to be able to comprehend the nature and effect of the transaction may be voidable. This is allowed very rarely since courts may view the intoxicated person as being at least partly responsible for their condition.

b. Being drunk is not a good excuse to disaffirm a contract.

4222.23 Private corporations

- **a.** A private corporation exceeding its scope of power is held liable on its contracts.
- **b.** *Ultra vires*: Beyond the corporation power.

4222.24 Public corporations

- **a.** A city or a town is an example of a public corporation.
- **b.** There is generally no recovery against a public corporation that exceeds its legal limits in making a contract.

Statute of Frauds

4222.25 Certain contracts must be in writing and signed by the party to be charged or the contract is unenforceable if the statute of frauds is raised as a defense.

4222.26 The party to be charged is the party that is being sued to be held liable on the contract.

4222.27 The writing may be a note, a memorandum, an informal notification, or more than one writing. The writing must meet the test of reasonable certainty and should contain the name of the parties, subject matter, and material terms and conditions.

4222.28 Sale of goods

- **a.** A contract for the sale of goods for a price of $500 or more must be in writing to be enforceable.
- **b.** **Exceptions** (see UCC 2-201):
  - (1) Between merchants, an oral contract is enforceable if one of the merchants sends a written confirmation to the other and receives no objection within 10 days after sending it. Both merchants are bound on the oral contract.
  - (2) If the goods are specially manufactured (for a unique purpose and cannot be resold as shelf items), the oral contract is enforceable if the manufacturer has made a substantial start on their manufacture before the other party tries to withdraw from the contract.
  - (3) If the goods have been paid for and accepted or received and accepted, the oral contract is enforceable. If there has been only a partial acceptance of the goods or a partial payment, the contract is enforceable only to that extent.
  - (4) If the person admits in court to have contracted with the plaintiff, the contract is enforceable to the quantity admitted.

4222.29 **Securities.** Any contract for the sale of securities must be in writing to be enforceable.

4222.30 Sale of intangible personal property (e.g., a patent, copyright, or royalty right) for more than $5,000 must be in writing.

4222.31 Transfer of an interest in land

- **a.** Transfer of any interest in real property must generally be in writing.
- **b.** This provision would include sale of real estate, giving a lien (mortgage) on the real estate, certain leases of real estate, and granting an easement.

- **c.** Agreements to build on real estate, do other work such as landscaping, or to lend money to buy real estate do not generally have to be in writing to be enforceable.
- **d.** **Exception:** An oral contract for the sale of real property is enforceable if the buyer takes possession and/or makes valuable improvements on the land. This is called the doctrine of part performance. A valuable improvement might be building a house on the land.

4222.32 Contracts that cannot be performed within one year

- **a.** An executory, bilateral contract that cannot be performed within one year of making the contract is not enforceable unless it is in writing.
- **b.** Time starts from the time of making the contract, not from the time of expected performance.
- **c.** If it is possible to perform the contract within one year, no matter how improbable, an oral contract is enforceable.

4222.33 A promise to pay the debt of another must be in writing to be enforceable.

- **a.** This is called *suretyship*.
- **b.** The person making the promise to pay the debt of another is called a surety or a guarantor.
- **c.** The promise must be to the creditor. This is referred to as a collateral promise rather than an original promise.
- **d.** An oral promise to the debtor to pay the debtor's debt is enforceable even if oral. It was not made to the creditor and is considered an original promise.
- **e.** **Exception:** An oral promise made to the creditor to pay the debt of the debtor made solely to benefit the person making the promise. It is called the main purpose doctrine or the leading objective rule.

4222.34 Promise when one and only one of the promises is a promise to marry

- **a.** Must be in writing to be enforceable
- **b.** Mutual promises to marry may be oral and still be enforceable.
- **c.** **Example:** Father promises boy $10,000 if he promises to marry daughter. Boy will not get the $10,000 if father does not want to pay if it was an oral promise.

Parol Evidence Rule

4222.35 **Parol-extrinsic:** Evidence about the agreement that is not in the written agreement. It is outside the agreement and usually oral.

4222.36 **Parol evidence rule.** Extrinsic (oral or written) evidence is not admissible to add to, alter, or vary the terms of a written contract. The reason is that all preliminary negotiations are merged into the writing.

4222.37 It is acceptable to make an oral contract and a written contract at the same time if the subjects of the contracts are different.

4222.38 It is not a violation of the parol evidence rule to admit oral testimony to prove or explain the following:

- **a.** The contract was obtained by fraud, misrepresentation, duress, or undue influence.
- **b.** The contract was illegal.
- **c.** An oral condition precedent to the contract. Until the condition precedent happens, the contract does not come into existence.
- **d.** A subsequent modification has been made to the contract. This could be oral or written.
- **e.** Ambiguous terms in the written contract. Oral testimony would clear it up.
- **f.** The contract is voidable due to a party being a minor or being insane.
- **g.** Fill in blank spaces regarding nonmaterial terms if the written contract is incomplete. These terms cannot vary, alter, or contradict the written contract.

Interpretation of Contracts

4222.39 If the terms of a contract are unclear or conflict, the court will apply principles of construction and interpretation.

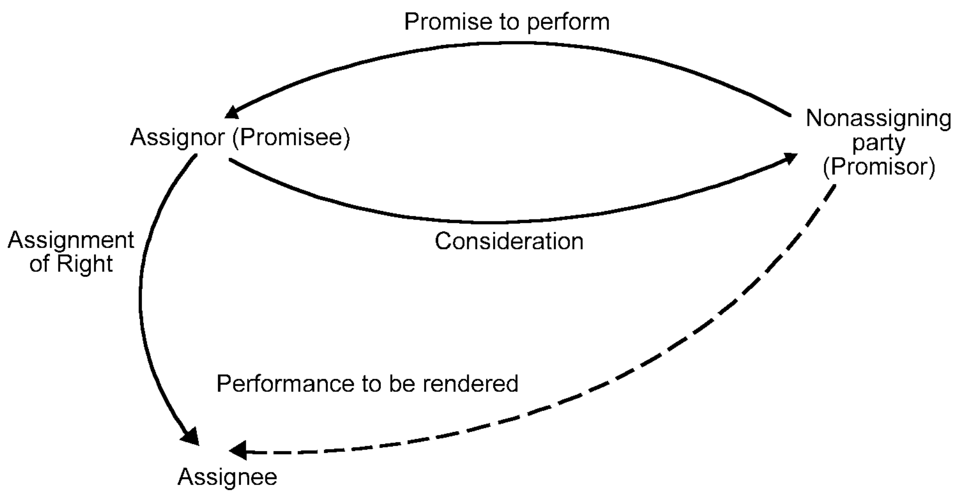
4222.40 Under rules of interpretation and construction for contracts:

- **a.** > means “control” for purposes of this list.
- **b.** The contract is construed as a whole, not in parts. The whole contract is read with all words and sentences taken in context.
- **c.** Written > typed > printed. Written provisions of a contract are more likely to be current than printed words on a preprinted contract.
- **d.** Specific > general. If there is an inconsistency, the specific provisions control and qualify the meaning of the general provisions.
- **e.** Lawful > unlawful. If a provision can be interpreted in both a lawful and unlawful manner, it is assumed that the parties intended a lawful purpose.
- **f.** Words > figures to determine amount or quantity.

  Example: A check says “$467.88” and “Four hundred seventy-six dollars and eighty-eight cents.” The amount the bank will pay is $476.88 (words) instead of $467.88 (figures). Figures are easier to transpose than are quantities written in words.
- **g.** Public > private. Where the public interest is affected, an interpretation is preferred that favors the public interest over any private interests of the parties.
- **h.** Nondrafter > drafter. Since the drafter wrote the contract, he/she has already had the opportunity to clear up any ambiguity. Therefore, any ambiguity will be resolved in favor of the nondrafter by construing the contract language most strongly against the drafter.

Assignments of Contracts

4222.41 Assignment of contracts



a. An assignment involves a transfer by one party to a contract of some or all of the rights to another person who is not a party to the original contract.

b. Agreement or consent of the nonassigning party is not needed unless the contract requires consent. In mega-leases, there is often a consent clause.

c. **Assignor:** Transferor. The party that transfers the rights.

d. **Assignee:** Transferee. The party that gets the rights from the transfer.

e. No special language is necessary to make an assignment.

f. May be a total transfer or partial transfer of the contract by the assignor.

g. No consideration is necessary. The assignment may be part of another contract or it may be gratuitous.

h. When a right is assigned, the assignor normally no longer has any interest in the right.

4222.42 Contracts ordinarily are assignable.

a. An offer to enter into a contract is not assignable.

b. Rights (legal ability to get something from the other party) are almost always assignable.

4222.43 Contracts not assignable

a. Contracts involving personal services, such as an employment contract.

Example: Your employer could not assign your employment contract to the local garbage department to work on the garbage truck.

b. Contracts that involve the personal satisfaction of one of the parties.

Example: An artist tells you that you need not pay the $100 fee for painting your portrait unless you are personally satisfied. You could not assign the contract to someone else who might be more critical of any painting.

c. Contract that states the contract is not assignable can generally not be assigned.

(1) A person may assign the right to sue the other party for damages even though the contract prohibits assignment.

(2) A creditor may assign the contract of an account debtor even though the contract prohibits assignment.

d. Contracts where the assignment would treat the nonassigning party unfairly by doing the following:

(1) Materially changing the duties under the contract

(2) Materially increasing the burden or risk under the contract

(3) Materially impairing the chance of obtaining return performance

4222.44 Effect of assignment

a. Liability of assignor: Still liable to the nonassigning party on the contract for the promised consideration.

b. Liability of assignee: Not liable just because of receiving the assignment. The nonassigning party may be able to sue the assignee if the nonassigning party is a creditor beneficiary of the contract between the assignor and assignee.

c. Rights of assignee: Assignee gets all the rights of the assignor. Any defenses the nonassigning party has against the assignor can be asserted against the assignee (up to the amount of the assignment).

d. To protect the right to receive performance, the assignee should notify the nonassigning party of the assignment. If there is no notice and the nonassigning party performs for the assignor, their duty under the contract is discharged.

e. If no notice is given and the nonassigning party performs for the assignor, the assignee can sue the assignor for damages.

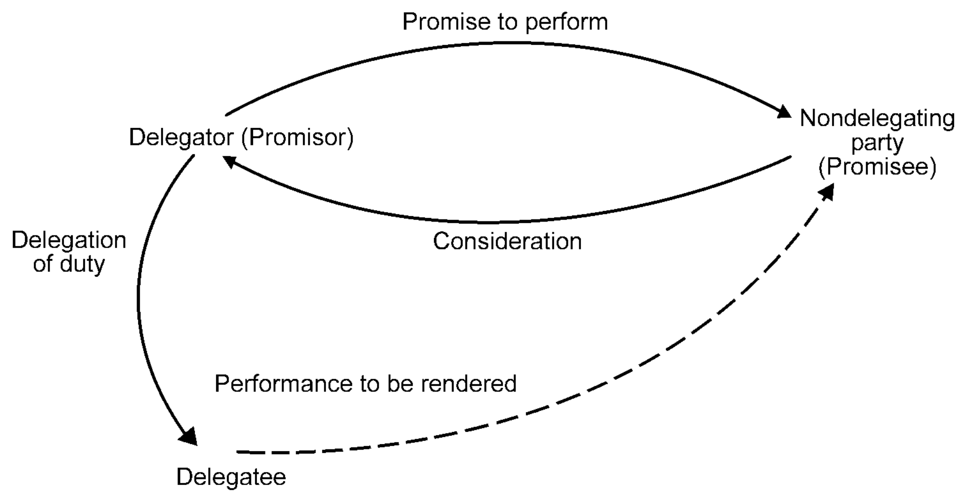
4222.45 Priorities among successive assignees when the assignor assigns the same rights to more than one assignee

a. American rule: First assignee in point of time prevails. Once the assignment is made, the assignor has nothing left to assign.

b. English rule: First assignee to give notice to the nonassigning party prevails.

Delegation of Duties

4222.46 **Delegation of duties** (legal obligations to do something for another party)



4222.47 Delegation involves the appointment by the delegator of the delegatee to render performance on the delegator's behalf.

4222.48 Though the terms are often used interchangeably, assignment and delegation are the flip sides of the coin. Rights are assigned. Duties are delegated.

4222.49 When a duty is delegated, the delegator is still liable to the nondelegating party for any defective performance by the delegatee. The delegator is relieved from liability only if the nondelegating party agrees to release by way of a novation (see section **4223.13**).

4222.50 **Nondelegable duties**

- **a.** A duty is nondelegable when performance by the delegate would vary materially from performance by the delegator.
- **b.** If the contract is based on the artistic skill or unique ability of the delegator, the duty to perform is nondelegable.
- **c.** If the duties under the contract simply call for mechanical skills, which can be tested by objective standards, the duty to perform is delegable.
- **d.** **Examples:**
  - (1) A contract duty to paint a portrait would generally be nondelegable, because it involves unique abilities and artistic skill.
  - (2) A contract duty to install a concrete driveway would generally be delegable, because this usually would involve only mechanical skills that can be tested by objective standards.

4223 Discharge, Breach, and Remedies

Remedies for Breach of Contract

4223.01 Contract remedies are intended to put the injured party in the same position as if the contract had been performed insofar as possible. If the legal remedy of damages is not adequate, the equitable remedies of specific performance, rescission, or injunction may be used.

4223.02 Compensatory damages

a. For sale of goods contracts

(1) If buyer has the goods and title has transferred to buyer— the contract price.

(2) If seller has the goods and no title has transferred—the difference between the contract price and the fair market value. If not a stock item, the seller will have to sell the goods in a good faith transaction (not to a related party) to determine the fair market value.

(3) Seller will not deliver the goods—the difference between the contract price and the fair market value. Buyer will have to buy an identical item from another seller (called covering) to establish the fair market value. If the buyer is able to get the goods from another seller at a price that is lower than the contract price, the buyer need not refund the savings. There would be no compensatory damages.

b. For sale of services

(1) Seller will not perform—difference between fair market value of getting the services done and the contract price.

(2) Buyer refuses to accept the services—profit that would have been made by the seller.

c. Damages include any expense that is reasonably foreseeable with whatever knowledge the breaching party has.

4223.03 Nominal damages

a. A small sum, like $1, would be awarded for breach of contract either:

(1) with no compensatory damages or

(2) when unable to prove damages with reasonable certainty.

b. No logical person would sue if they expected to collect only nominal damages. They would still have to pay attorney fees and would actually lose money by bringing the suit. In awarding nominal damages, the court merely pats the winner on the back, says they were in the right, and awards them a small amount.

4223.04 Special damages

a. These are damages that would not be foreseen unless a person has some special information about the circumstances.

b. The wronged party can recover these special damages only if the breaching party has this special information. With this specific information the damages would be foreseeable.

4223.05 Liquidated damages

a. Amount of damages is agreed upon in advance and included in the contract. This provision is found in sophisticated contracts. Often the easy part of a lawsuit is establishing a breach. The second issue is establishing the damages. The liquidated damages provision is often included to avoid this second issue.

b. Used where the actual compensatory damages would be difficult to determine (e.g., breach of construction contracts)

c. The court will enforce liquidated damage provisions in a contract if they were a reasonable estimate of the probable loss when made and are not a penalty used to prevent a breach. Because both contracting parties negotiated the amount of liquidated damages, the defaulting party will have a heavy burden in arguing that the amount was not reasonable. Most contracts include a sentence that the liquidated damages are not to be construed as a penalty.

d. If the courts find the liquidated damage provision to be a penalty, they will disregard the provision and make the party try to prove compensatory damages.

4223.06 Mitigation of damages. After a breach, the injured party must take steps to minimize further loss. The injured party failing to take this action will not be able to collect the additional portion of the damages that could have been prevented.

4223.07 Restitution

a. An equitable remedy available only if damages would be inadequate to make the nonbreaching party whole.

b. Also called *rescission.*

c. Restitution involves return to the injured party of the consideration given or its value.

4223.08 Specific performance

a. An equitable remedy available only if damages would be an inadequate remedy for breach of the agreement.

b. Two common examples of specific performance:

(1) **Contract to buy (not sell) land.** Each piece of land is unique unto itself. The buyer could not go into the marketplace and buy an exact equivalent.

(2) **Purchases of unique personal property.** These are one-of-a-kind items. They would also include items like the controlling interest stock of a corporation. The buyer could not go into the marketplace and buy the same item.

c. The promise must be clear and relate to a specific identifiable item.

d. No specific performance for the following:

(1) **Building contract.** Too difficult for the court to supervise.

(2) **Personal services.** This would be involuntary servitude prohibited by the Thirteenth Amendment of the U.S. Constitution. Courts will enforce a negative injunction to prohibit the individual from doing that type of work during the period of the contract. This has happened when a professional basketball player jumped to a new league but still had a contract with the old team.

Discharge of a Contract

4223.09 Discharge: End of a contractual obligation.

4223.10 Discharge related to conditions

a. Condition precedent not happening

(1) A condition precedent must occur before a contractual obligation comes into existence.

(2) **Example:** Buyer agrees to purchase a house on condition that he can obtain a $90,000 loan at 7.75% or lower within the next 30 days. Being able to get the loan is a condition precedent to being obligated to purchase the house.

b. Condition subsequent happening

(1) A condition subsequent ends an existing contractual obligation.

(2) **Example:** Returning the goods in 10 days and getting a full refund if you are not satisfied. This is a condition subsequent that terminates the promise to pay a refund for the goods after 10 days have passed.

4223.11 Performance of the contract

a. Complete performance

(1) Discharges the contract

(2) Must be exactly as agreed

b. Substantial performance

(1) Slightly less than complete performance where there is technically a breach, but it is not material

(2) Allows the person to recover the contract price less the amount needed to complete the contract

(3) Usually applies to construction contracts where it is an oversight rather than intentional

c. Partial performance

(1) Less than substantial performance

(2) Allows the person to recover only by a quasi-contract (contract implied in law) for the value of the services rendered. A quasi-contract is imposed only when unjust enrichment would result.

4223.12 Payment

a. Full payment discharges the obligation.

b. Payment by check is conditional upon the check being paid by the bank.

c. Partial payment:

(1) Must be applied as directed by the debtor

(2) If the debtor does not specify, the creditor may apply it in any way.

(3) It may even be applied to a debt which would be unenforceable because the statute of limitations has run out.

d. Consumer credit statutes may give the priorities of application to the creditor for some types of transactions.

4223.13 Novation: A three-party agreement where the creditor agrees to release the debtor and take some third party as a substitute. The novation discharges the contractual obligation of the original debtor. Novations are rare because the original debtor is discharged.

4223.14 Accord and satisfaction

a. Accord: Agreement between the two contracting parties where some different performance will replace the original performance. An accord by itself does not discharge the contractual obligation.

b. Satisfaction: Carrying out the accord

c. An accord and satisfaction discharges the contractual obligation.

4223.15 Impossibility of performance

a. Subjective impossibility—it is inconvenient or too expensive to carry out the contract—does not discharge the contract.

b. Objective impossibility—discharges the contractual obligation

(1) Nobody could carry out the contract. This is real impossibility.

(2) Either of the following would be objective impossibility:

(a) The subject matter of the contract is destroyed after making the contract but before performance is due.

(b) The person who is to perform a personal services contract dies after making the contract but before the performance is due.

c. Doctrine of commercial frustration—excuses contractual performance if both parties contemplated the happening of some event that does not occur

Example: Coronation case in England. People rented apartments to see the parade, but the king got sick and the parade was canceled.

4223.16 Release

a. Give up the legal right to sue the other party on a contract.

b. It discharges the other party.

c. A release of one joint obligor releases all other joint obligors.

4223.17 Covenant not to sue

a. Promise not to sue a person, discharges that person.

b. Promise not to sue does not affect other joint obligors.

4223.18 Operation of law

a. The statute of limitations runs out so that a lawsuit can no longer be filed to enforce the contract.

b. The person is discharged of the debt through bankruptcy proceedings.

4223.19 Breach

a. Failure to perform without a valid reason

b. Breach by one party discharges the duty of performance by the other party.

4223.20 Anticipatory breach

a. Repudiation of the contract by informing the other party that the contract will be breached when performance is due

b. Other party may do either of the following:

(1) Wait and do nothing until the time for performance passes.

(2) Sue immediately for the breach even though the time for performance has not yet arrived; however, damages may be difficult to establish. (See liquidated damages as discussed in section **4223.05**.)

Joint and Several Contracts

4223.21 Joint contracts

a. Two or more persons jointly promise to perform an obligation.

b. Suit must be brought against all joint promisors.

c. Judgment may be levied against one of the joint promisors.

d. A release of one joint obligor releases all of them.

e. If one joint promisor dies, the remaining promisors remain obligated to perform.

f. A promise by two or more persons is presumed to be joint.

g. "We jointly promise" is a joint contract.

4223.22 Several contracts

a. Severally = individually

b. Two or more persons who separately agree to perform the same obligation may be sued individually.

c. If one of several obligors dies, his estate is liable on the obligation.

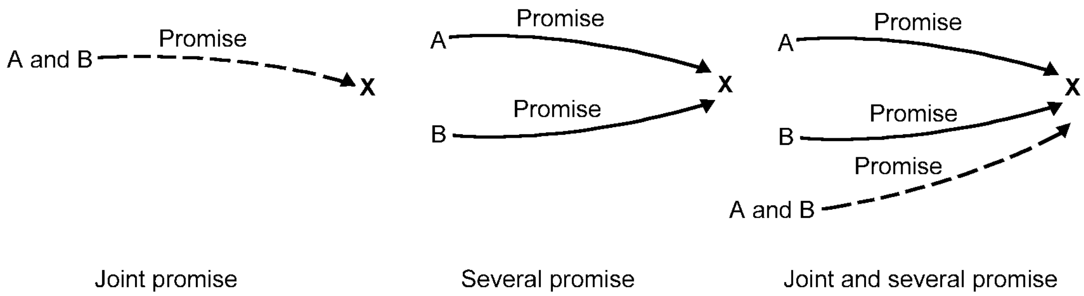
d. A release of one obligor has no effect on the other.

e. "Each of us promises" or "We severally promise" is a several contract.

4223.23 Joint and several contracts

a. Two or more persons are bound both jointly and severally.

b. “We, and each of us, promise” are joint and several contracts.



4230 Debtor-Creditor Relationships

4231 Rights, Duties, and Liabilities of Debtors, Creditors, and Guarantors

4231.01 The rights and duties of debtors and creditors outside of bankruptcy are governed primarily by state law.

4231.02 Once a debt is past due, a creditor may file a legal action against the debtor in order to obtain a judgment and satisfy the claim out of the debtor’s property.

4231.03 State law also provides a number of nonbankruptcy compromises that may be used to provide relief for a debtor.

Attachment

4231.04 Attachment is the prejudgment, court-ordered seizure of property of the debtor.

4231.05 The creditor can make use of an attachment to ensure that assets of the debtor are available to satisfy a judgment obtained by the creditor.

4231.06 The creditor’s attachment rights are created by state statute.

4231.07 To make use of the remedy of attachment, the creditor generally must do the following:

a. File an affidavit with the court showing the debtor to be in default and the statutory grounds for the attachment.

b. Post a bond with the court to compensate the debtor for any loss suffered if the creditor fails to win the suit.

4231.08 If all of the requirements are met, the court will issue a writ of attachment ordering a court officer (sheriff) to seize property of the debtor.

4231.09 If the creditor wins the suit, the attached property can be sold to satisfy the judgment.

Writ of Execution

4231.10 If a court judgment is obtained against the debtor, the creditor may have to resort to post-judgment remedies to collect.

4231.11 If the debtor does not voluntarily pay the judgment, the creditor will have the clerk of courts issue a writ of execution.

4231.12 The writ of execution is a court order directing an officer of the court (sheriff) to levy against (seize) specific property of the debtor.

4231.13 The debtor's property is then sold at a judicial sale and the proceeds are used to pay the judgment and the costs of the sale. Any excess is returned to the debtor.

4231.14 The debtor generally has the right to redeem the seized property before the sale takes place by paying the amount of the judgment.

Exempt Property

4231.15 Most states provide for the exemption of certain property of the debtor from attachment or execution. The exact property that is exempt varies greatly from state to state.

4231.16 All states provide a homestead exemption under which either the entire family home or a specific dollar value of the home is exempt from attachment or execution by creditors. This exemption generally would not apply to a valid home mortgage lien.

4231.17 Most states also provide exemptions for certain personal property of the debtor. The most common items include the following:

- **a.** Household furnishings up to a specific dollar amount
- **b.** A motor vehicle (for a specific dollar amount)
- **c.** Clothing and certain personal possessions (e.g., family photos) of the debtor
- **d.** Equipment and tools used in the debtor's trade or business up to a specific dollar amount

4231.18 Exempt property would generally not be exempt from an IRS tax lien resulting from a failure to pay tax.

Garnishment

4231.19 Garnishment is a statutory remedy of the creditor that is directed at a third party, rather than the debtor.

4231.20 The third party (garnishee) must either owe a debt to the debtor or be holding property that belongs to the debtor.

4231.21 As a result of the garnishment, the third party is ordered to turn over the payment of the debt or the property of the debtor to satisfy the creditor's judgment.

4231.22 The most common garnishments are served on the debtor's employer to garnish the debtor's wages or upon a bank to garnish the funds in the debtor's accounts.

4231.23 Both federal and state laws limit the amount that can be garnished from the debtor's weekly wages. Similar to the property exemptions described in section **4231.17,** the limitation allows the garnishee sufficient funds to continue to work.

Composition Agreement

4231.24 A composition agreement is an agreement between the debtor and the creditors whereby the creditors receive a pro rata portion of the debt owed them in exchange for a promise to forgive the rest of the debt.

4231.25 The agreement must meet all of the requirements of a contract.

4231.26 The consideration for the promise of each creditor to forgive the balance of the debt owed to them is the promises of the other creditors to forgive the balance of their claims against the debtor.

4231.27 The debtor is released only from the claims of the creditors who agree to the composition. Other creditors may still pursue judicial remedies such as attachment of the debtor's property.

Assignment for the Benefit of Creditors

4231.28 In an assignment for the benefit of creditors, the debtor voluntarily transfers property to a trustee. The trustee uses the property to pay the debtor's creditors on a pro rata basis.

4231.29 An assignment does not require the consent of the creditors. Each creditor may also choose to accept or reject the partial payment.

4231.30 Acceptance of partial payment from the trustee does not legally discharge the debtor from the balance of the debt. The creditors can still attempt to collect the full amount of their claims unless they agree to forgive the balance by way of a composition agreement.

Equity Receivership

4231.31 In an equity receivership, the court appoints a receiver to collect the assets and income of the debtor.

4231.32 The receiver is appointed to handle the debtor's affairs upon petition of a creditor.

4231.33 The court then orders the receiver to take such action as the following:

- **a.** Liquidating the debtor's assets by way of public or private sale in order to pay creditors
- **b.** Operating the debtor's business for a period of time in order to continue a stream of income that can be used to pay creditors' claims

Fair Debt Collection Practices Act

4231.34 The Fair Debt Collection Practices Act (FDCPA) is a federal statute that was passed to control abuses in the debt collection process.

4231.35 The FDCPA regulates the collection of consumer debt. Consumer debt is defined as debt that arises for personal, family, or household purposes.

4231.36 Commercial debt, such as debt arising from the purchase of inventory, is not covered by the FDCPA.

4231.37 The FDCPA applies to debt collectors. Debt collectors are defined as third-party collectors, such as collection agencies.

4231.38 The FDCPA rules do not apply to original creditors collecting their own debts.

4231.39 Debt collectors must provide written verification of the debt if the debtor asks. Collectors must automatically provide written verification within five days of contacting the debtor. This writing must include the following:

- **a.** The amount of the debt
- **b.** The name of the creditor
- **c.** The debtor's right to dispute the debt in writing within 30 days

4231.40 If the debtor disputes the debt, the debt collector must cease all further collection efforts until it supplies the debtor with a written verification of the debt. Verification can be satisfied by either of the following:

- **a.** A judgment evidencing the debt
- **b.** A statement itemizing the debt owed by the consumer and the consideration the debtor received

4231.41 The FDCPA provides restrictions on the debt collector's contact with the debtor. Among these are the following:

- **a.** Debtors cannot be contacted at inconvenient times, generally before 8:00 in the morning or after 9:00 at night. Debtors who work at night cannot be disturbed during their daytime sleeping hours.
- **b.** Debtors cannot be contacted at their place of employment if the employer objects or has a policy prohibiting such contact.
- **c.** If the debtor notifies the collector in writing that the debtor wants no more contact, the collector must stop contacting the debtor and take other steps to collect the debt.
- **d.** If the debtor has an attorney and notifies the collector of this fact, the collector can generally contact only the attorney from that point on.

4231.42 Debt collectors are generally prohibited from communicating with third parties about the debt.

- **a.** Third parties may be contacted only to obtain information to locate the debtor such as address, phone number, or place of employment.
- **b.** When contacting third parties, debt collectors are prohibited from doing the following:
  - (1) Disclosing that the debtor owes a debt
  - (2) Communicating with the third party (or debtor) by postcard
  - (3) Disclosing in correspondence that the sender is in the debt collection business
  - (4) Identifying the debt collector's employer unless expressly requested

4231.43 Other conduct is also restricted under the FDCPA. For example:

a. Collectors may not harass, oppress, or abuse the debtor.

b. Debt collectors may not falsely misrepresent that they:

(1) are affiliated with the government,

(2) are attorneys,

(3) have sold the debtor's account to another, or

(4) will take actions that they cannot lawfully take.

4231.44 Remedies available under the FDCPA include the following:

a. The Federal Trade Commission is responsible for enforcement of the act.

b. Under the FDCPA, debtors can bring civil actions against collectors who violate the act. Debtors can recover damages for actual injuries suffered.

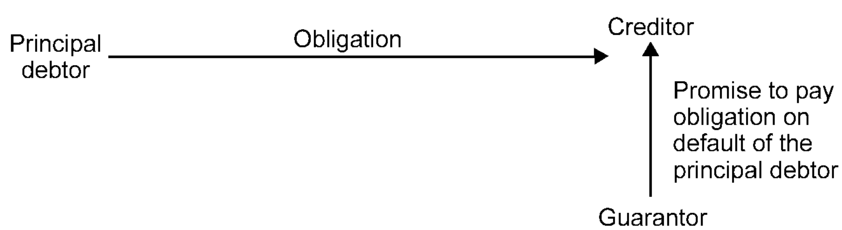
c. Debtors can collect up to $1,000 in addition to actual damages based upon the nature of the collector's conduct.

d. Attorneys' fees and court costs may also be recovered by debtors under the act.

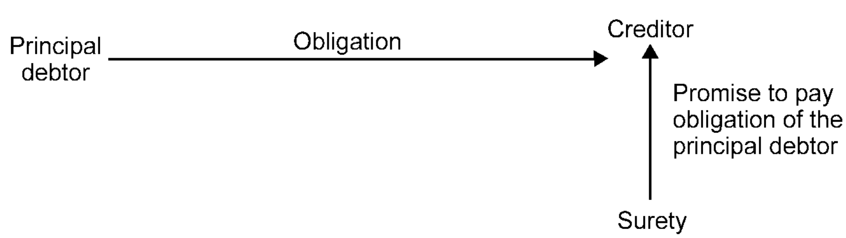
Rights, Duties, and Liabilities—Guarantors

4231.45 Parties that promise a creditor that they will be liable for the principal debtor's performance are either guarantors or sureties.

4231.46 **Guaranty:** Relationship among three parties in which the guarantor promises to pay the obligation of the principal debtor that is owed to the creditor if the principal debtor defaults on the obligation.



4231.47 **Suretyship:** Relationship among three parties in which the surety promises to pay the obligation of the principal debtor that is owed to the creditor.



4231.48 Difference between guarantor and surety

a. Guarantor:

(1) Liability created in some other instrument from that of the principal debtor—often at a different time.

(2) Promise to perform if the debtor cannot perform. The guarantor is *secondarily* liable.

(3) "I will pay if the debtor cannot pay."

(4) The creditor needs to demand payment from the debtor and give notice of default to the guarantor to collect from the guarantor.

(5) The promise of the guarantor is said to be collateral to that of the principal debtor.

b. Surety:

(1) Liability is created concurrently with that of the debtor.

(2) Promise to do the same thing the debtor promises. The surety is *primarily* liable.

(3) "I will pay if the debtor does not."

(4) The creditor does not need to demand payment from the debtor to collect from the surety.

(5) Liability is established in the same instrument as the principal debtor.

The legal rights and duties of guarantors and sureties are similar but note the technical but important difference in *a.(4*) and *b.(4)* above.

4231.49 Consideration: Legally sufficient consideration is required to make a suretyship or guaranty contract enforceable.

4231.50 Statute of frauds

a. Any promise to pay the debt of another person is unenforceable unless there is a writing signed by the party to be charged.

b. The statute of frauds applies only to guaranty contracts because they involve secondary promises. Surety contracts, which involve primary promises to pay, do not fall under the statute of frauds.

c. Promise must be made to the creditor to fall within the statute of frauds. If the promise is made to the principal debtor, the promise is valid and enforceable even if oral.

4231.51 Main purpose doctrine: This is an exception to the statute of frauds when the promise is made for the primary benefit of the promisor. This means that an oral promise to pay the debt of another is enforceable if the oral promise was made primarily to benefit the promisor.

4231.52 Classification of guarantors and sureties:

a. Unconditional or absolute

(1) Binds the guarantor unconditionally to perform the obligation.

(2) Absolute guarantor becomes liable when debtor defaults. Nothing else is needed.

(3) Suretyship contracts are unconditional unless a condition is present.

b. Conditional

(1) Binds the guarantor only after the performance of some act by the creditor.

(2) Typical acts that make liability conditional include the following:

(a) Unsuccessful attempt to collect from the debtor

(b) Unpaid judgment

(c) Showing it would be futile to proceed to a judgment against the debtor

c. General

(1) Addressed "To whom it may concern"

(2) Any creditor who has knowledge of the guaranty and extends credit may enforce the guaranty.

d. Special: Addressed to a particular person.

e. Temporary (or limited or single): Limited to a single transaction, a specified period of time, or a specified maximum amount.

f. Continuing

(1) Contemplates a transaction of indefinite time

(2) May be a series of credits or a credit line

g. Compensated: Person who agrees to serve as a surety and receives compensation (usually money) for undertaking the risk. An example would be a bonding company.

h. Noncompensated (also called accommodation): Person who agrees to serve as a surety without compensation. Courts tend to discharge the noncompensated surety from an obligation for any change the creditor makes in the contract with the principal debtor.

4231.53 Rights of creditor: A creditor may proceed against the principal debtor alone, the surety alone, the surety and the principal debtor, or foreclose on any security interest furnished by the principal debtor, or against the guarantor after default by the principal debtor.

4231.54 Defenses available to the principal debtor:

a. Discharge in bankruptcy. This is a personal defense available only to the principal debtor. This defense may not be used by the guarantor or surety to avoid paying the creditor.

b. Minority of the principal debtor. This is a personal defense available only to the principal debtor. (Minority generally refers to being under the age of 18.) This defense may not be used by the guarantor or surety to avoid paying the creditor.

c. Performance of the obligation. If the principal debtor has done what was promised, the creditor or the surety cannot insist that the debtor do it again.

d. Breach of contract by the creditor. Like any other contract, the wrongdoer cannot insist on performance if the wrongdoer has not done what they promised to do.

4231.55 Defenses available to the guarantor or surety to avoid liability to the creditor:

a. All nonpersonal defenses of the principal debtor are available. Remember that bankruptcy and minority of the debtor are personal defenses not available to the guarantor or surety.

- **b.** **Minority or bankruptcy of the guarantor or surety is a defense.** Minors can avoid liability on all contracts, even guarantor or suretyship contracts.
- **c.** **Creditor's fraud or nondisclosure of something important.** For example, the creditor does not tell the surety that one of the principal debtor's employees was embezzling money.
- **d.** **Creditor modifying principal debtor's contract.** For example, the creditor extends the time for the principal debtor to repay.
- **e.** Creditor's release of security or co-guarantors or co-sureties
- **f.** Creditor's release of the principal debtor
- **g.** Anything the creditor does that will hurt the guarantor's or surety's chance of coming out whole will discharge the surety from the obligation to the creditor.
  - (1) Courts tend to release the noncompensated guarantor or surety for any change in the contract.
  - (2) For a compensated guarantor or surety, only the amount lost due to the change will be excused.

4231.56 **Remedies of the guarantor or surety:**

- **a.** **Defense:** Use a defense to avoid payment to the creditor.
- **b.** **Reimbursement or indemnity:** Get the principal debtor to pay the guarantor or surety for the amount the guarantor or surety had to pay the creditor.
- **c.** **Subrogation:** When the guarantor or surety discharges the principal debtor's obligation to the creditor, the guarantor or surety gets all the creditor's rights regarding the obligation.
- **d.** **Contribution:** From co-guarantor or co-sureties for paying more than legally obligated.

4231.57 **Surety bonds:** These bonds are an acknowledgment of an obligation to make good the performance by another of some act or duty.

- **a.** **Common-law bonds:** No law requiring them
- **b.** **Statutory bonds:** Required by statute
- **c.** **Construction bonds** (performance bonds):
  - (1) Cover the performance of a contract
  - (2) Often used in construction contracts and supply contracts
  - (3) May cover laborers and materialmen as third-party intended beneficiaries to the contract between the creditor and the surety. Remember that third-party intended beneficiaries can sue to enforce the contract.
  - (4) Subclassifications
    - (a) Performance bonds—for performance of work
    - (b) Payment bond—for payment of laborers and materialmen
  - (5) Miller Act
    - (a) Federal act that requires a performance and payment bond on all construction contracts for the federal government for more than $2,000

(b) Not required for construction that is only financed by the federal government (e.g., Federal Housing Administration)

d. Fidelity bonds

(1) These bonds indemnify the employer against loss from dishonesty of an employee.

(2) Surety gets right of subrogation against a wrongdoing employee.

e. Official bond: Required on some public officials that have custody of public funds

f. Judicial bonds

(1) Required in connection with judicial proceedings to indemnify the other party against damages resulting from the proceedings

(2) Examples:

(a) Bail bond

(b) Appeal bond

(c) Injunction bond

(d) Attachment bond

4232 Bankruptcy and Insolvency

4232.01 Bankruptcy results when the intended performance of the debtor becomes impossible due to excessive debt. The solution is to take the debtor's property and distribute it to the unpaid creditors through a uniform process.

4232.02 The U.S. Constitution contains an express provision allowing Congress to enact uniform bankruptcy laws. Major bankruptcy laws were enacted in 1898, 1938, 1978, and 2005. The most recent major revision is the Bankruptcy Prevention and Consumer Protection Act of 2005.

4232.03 Reasons for a bankruptcy law

a. Fair distribution of the debtor's property so that there is equal treatment of unsecured creditors

b. To give honest but overextended debtors a fresh start through discharge of debts or postponement of the time for payment

4232.04 The chapters on topics of the Bankruptcy Law are as follows:

Chapter	Topic
1	General Provisions
3	Case Administration
5	Creditors, the Debtor, and the Estate
7	Liquidation
9	Adjustment of Debts of a Municipality
11	Reorganization
12	Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income
13	Adjustment of Debts of an Individual with Regular Income
15	Ancillary and Other Cross-Border Cases

Written Notice to Consumer Debtor

4232.05 Before a bankruptcy case is commenced by an individual whose debts are primarily consumer debts, the bankruptcy clerk must give the individual written notice containing the following:

a. A brief description of:

(1) Chapters 7, 11, 12, and 13 and the general purpose, benefits, and costs of proceeding under each of those chapters and

(2) the types of services available from credit counseling agencies

b. Statements specifying that:

(1) a person who knowingly and fraudulently conceals assets or makes a false oath or statement under penalty of perjury in connection with a bankruptcy case will be subject to fine, imprisonment, or both, and

(2) all information supplied by a debtor in connection with a bankruptcy case is subject to examination by the attorney general

Who May Be a Debtor Under Chapter 7

4232.06 A debtor under Chapter 7 must reside in the United States and have a domicile, a place of business, or property in the United States.

4232.07 The debtor in a proceeding under Chapter 7 cannot be any of the following:

a. A railroad

b. An insurance company

c. A domestic bank

d. Any other lending institution (like a credit union or a savings and loan association)

e. A governmental unit

4232.08 Debtors under Chapter 7 are not eligible for bankruptcy relief. These organizations are covered by special statutes, and their liquidations are supervised by certain regulatory agencies.

Voluntary Petition

4232.09 A voluntary petition is filed by the debtor.

4232.10 A voluntary petition may be filed jointly by husband and wife if both consent.

4232.11 Filing a voluntary petition automatically subjects debtors and their property to jurisdiction of the bankruptcy court.

4232.12 In a voluntary petition, the debtors need not be insolvent. They only need to show that they have debts.

4232.13 An individual must receive credit counseling from an approved nonprofit budget and credit counseling agency within 180 days before filing a voluntary bankruptcy petition.

- **a.** The debtor must participate in either individual or group sessions that outline opportunities for available credit counseling and assist the individual in related budget analysis.
- **b.** A certificate of compliance from the nonprofit budget and credit counseling agency must be filed with the petition.
- **c.** Exception may be made to the budget and credit counseling requirement:
  - (1) in districts where the bankruptcy trustee (or bankruptcy administrator, if any) determines that adequate budget and credit counseling services are not available.
  - (2) for debtors who are unable to complete the requirement due to incapacity (impairment by reason of mental illness or mental deficiency), disability (physical impairment), or active military duty in a military combat zone.

4232.14 The bankruptcy court may dismiss a voluntary bankruptcy petition for several reasons. These include:

- **a.** unreasonable delay by the debtor that is prejudicial to creditors,
- **b.** nonpayment of any fees or charges,
- **c.** failure of the debtor to file required documents and information within required time periods,
- **d.** the debtor has income above the average median family income for the state where the bankruptcy petition is filed,
- **e.** the debtor fails to pay post-petition alimony or child support,
- **f.** the debtor was convicted of a drug trafficking crime and the victim files a motion to dismiss the petition, or
- **g.** the debtor was convicted of a violent crime and the victim files a motion to dismiss the petition.

Involuntary Petition

4232.15 An involuntary petition is filed by the debtor’s creditors.

- **a.** If there are 12 or more creditors, 3 or more must file against a debtor if their total unsecured claims are at least $18,600. (Insiders or employees are not creditors.)
- **b.** If there are fewer than 12 creditors, 1 or more creditors must file if their total unsecured claims are at least $18,600.

4232.16 Involuntary petitions are allowed only for Chapter 7 (Liquidation) and Chapter 11 (Reorganization). There is no involuntary petition for Chapter 9 (Adjustment of Debt for a City) or Chapter 13 (Adjustment of Debt for an Individual with Regular Income). These last two types of bankruptcy proceedings are initiated only by a voluntary petition filed by the debtor.

4232.17 Involuntary petitions cannot be filed against any of the following:

- **a.** Farmer
- **b.** Wage earner
- **c.** Railroad, insurance, or banking corporation

d. Building and loan association

e. Nonprofit corporation

4232.18 When the involuntary petition is filed, the debtor and their property automatically come under the jurisdiction of the bankruptcy court if no challenge is made by the debtor.

4232.19 If the debtor contests the involuntary petition, the creditors must prove either of the following:

a. The debtor has not been paying debts as they come due.

b. The debtor's property has been placed in a receivership or an assignment for the benefit of creditors within 120 days before the involuntary petition was filed.

4232.20 A debtor involuntarily petitioned into bankruptcy under Chapter 7 of the Federal Bankruptcy Code who succeeds in having the petition dismissed could recover:

a. court costs and attorney's fees,

b. compensatory damages, and

c. punitive damages.

4232.21 The filing of the petition stays all pending actions by creditors against the debtor.

Estate

4232.22 The debtor's estate consists of all tangible and intangible property of the debtor, unless specifically exempted.

4232.23 The estate has the same interest as did the debtor in the property.

4232.24 The debtor's estate includes certain after-acquired property. Specifically, the estate includes any type of property that the debtor acquires, or becomes entitled to acquire, within 180 days after the petition filing date:

a. by inheritance,

b. as a beneficiary of a life insurance policy, or

c. as the result of a divorce decree or a property settlement agreement with the debtor's spouse.

4232.25 Earnings from services performed by the individual debtor after the filing of the petition are not included in the estate.

Exempt Property

4232.26 A debtor who is an individual (*not* a partnership or corporation) can claim certain exemptions. This exempt property is not included in the debtor's estate and is therefore not liquidated to pay the debts.

4232.27 Exemptions are established by either state or federal law.

4232.28 The debtor may choose to keep certain property either exempted by state law, or exempt under federal law, unless state law specifically disallows use of the federal exemptions.

4232.29 Federal exemptions from the bankruptcy law, if allowed by state law, include the following:

a. Up to $27,900 of the debtor's interest in a homestead (this may be either a house or trailer of the debtor used as a residence) or in a burial plot for the debtor or a dependent of the debtor

b. Up to $4,450 of the debtor's interest in one motor vehicle—the equity in the motor vehicle is based on the motor vehicle's market value.

c. Up to $700 for each item of furniture, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments held for personal, family, or household use of debtor or dependent of debtor—this exemption applies up to a maximum total of $14,875.

d. Up to $1,875 in jewelry for personal use

e. Up to $1,475 plus up to $13,950 of any unused homestead exemption in any other property that the debtor chooses

f. Up to $2,800 in implements, professional books, or tools of the trade

g. Any unmatured life insurance owned by the debtor other than a credit life insurance contract

h. Up to $14,875 in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract owned by the debtor under which the insured is the debtor or an individual of whom the debtor is a dependent

i. Right to receive Social Security, veterans', unemployment, or disability benefits, reasonable alimony, support, or separate maintenance payments

j. Professionally prescribed health aids for the debtor or dependent of the debtor

k. The debtor's right to receive, or property that is traceable to:

(1) an award under a crime victim's reparation law;

(2) a payment on account of the wrongful death of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(3) a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent on the date of such individual's death, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(4) a payment, not to exceed $27,900, on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent; or

(5) a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor

l. Retirement accounts which are tax exempt under the Internal Revenue Code. However, there is a cap on the exemption amount for IRAs of $1,512,350. This limit may be increased if "the interests of justice so require."

m. Certain contributions to qualified education savings accounts. To be excludible, the designated beneficiary must be a child, stepchild, grandchild, or stepgrandchild of the debtor for the tax year in which the funds were placed into the account. (Adopted and foster children also qualify.)

n. Contributions to qualified state tuition programs. These are excluded from the bankruptcy estate under the same monetary limits stated previously for contributions to qualified education savings accounts.

4232.30 State law often gives debtors exemptions for assets that differ from those allowed under the Federal Bankruptcy Code. In some states, a debtor can choose federal or state exemptions. In other states, debtors are required to use state exemptions.

Current bankruptcy law prevents a debtor from moving to a more generous exemption state shortly before filing in order to protect a greater amount of their assets. A debtor must have resided in the state for two years (730 days) in order to use that state's exemption law. If this time requirement is not met, the exemption rules of the debtor's prior state of residency apply.

Also, state homestead exemptions can vary from the federal amount, with some states allowing a homestead exemption of an unlimited dollar amount.

Right to Setoff

4232.31 **Setoff:** Subtracting receivables from payables to see how much is owed; subtracting payables from receivables to see how much is due.

4232.32 Setoff is always an advantage to creditors, since without setoff they would have to pay the full amount on payables but would get only a percentage of the receivables in the bankruptcy proceeding.

4232.33 A person who is both a debtor and a creditor of the debtor has the right to setoff.

Administration

4232.34 The debtor must file a list of creditors, schedule of assets and liabilities, statement of financial affairs, and list of property claimed as exempt.

4232.35 The debtor must cooperate with the trustee. If not, the court may not discharge the debtor.

4232.36 The debtor must appear at a meeting of creditors and answer questions.

4232.37 The trustee may operate the debtor's business.

4232.38 The trustee may void preferential or fraudulent transfers made by the debtor within 90 days of filing.

Possible Defenses to Challenge a Particular Transfer

4232.39 There are five general *requirements,* all of which must be present for the trustee to void a potential transfer:

1. Transfer goes to a creditor.
2. It must be in payment for a previous debt owed by the debtor.
3. It must have been made while the debtor was insolvent.

4. It must have been made within 90 days of filing the petition (one year if the creditor was an insider or had reason to think the debtor was insolvent). An insider is someone with a special relation to the debtor—for example, a relative or a partner.
5. The creditor got more than they would have received had the transfer not been made (usually considered to be the creditor's share of a Chapter 7 liquidation).

4232.40 The trustee cannot void the transfer under the following circumstances:

- **a.** If credit transactions are exchanges of equal value done at the same time (this is because the transfer does not reduce the value of the debtor's estate)
- **b.** If the creditor is acting in the ordinary course of business or in accordance with ordinary business terms
- **c.** If security interest is given in goods the debtor buys from the seller (called purchase money security interest)
- **d.** If the creditor gives new value to the debtor to offset the prior transfer by the debtor
- **e.** If creditors are holding a security interest in inventory or receivables
- **f.** For statutory liens that cannot be voided
- **g.** To the extent the transfer was a bona fide payment of a debt for a domestic support obligation
- **h.** In a case filed by an individual debtor, whose debts are primarily consumer debts, when the aggregate value of all property that constitutes or is affected by the transfer is less than $600
- **i.** In a case filed by a debtor whose debts are not primarily consumer debts, when the aggregate value of all property that constitutes or is affected by such transfers is less than $7,575

Transfers by a Debtor

4232.41 Transfers by a debtor that defraud creditors are always voidable.

4232.42 Transfers by the debtor can be voided by the trustee if made as follows:

- **a.** Within two years of filing with actual intent of defrauding creditors or
- **b.** Within two years of filing, and the debtor received much less than an equal exchange, and:
  - (1) was insolvent at the time of the transfer, or became insolvent because of the transfer,
  - (2) was left with an unreasonably small amount of capital, or
  - (3) intended or believed the debts would be beyond their ability to repay

4232.43 **Preferential transfers:** One creditor preferred over other creditors

4232.44 **Fraudulent transfers:** Defrauds all creditors

4232.45 **Transfer voids made before the filing of the bankruptcy petition:** The trustee can void fraudulent transfers made within two years prior to filing of the petition.

4232.46 **Transfer voids made after the filing:** (Remember, the debtor can continue to run the business even after filing unless the court orders the debtor not to.) The trustee must exercise this power within two years after the transfer is made or before the bankruptcy case is closed—whichever comes first.

4232.47 The trustee can cancel any contracts of the debtor based on any defenses that are available to the debtor (e.g., duress, undue influence, fraud, failure of consideration).

Claims

4232.48 Creditors present their claims to the court by filing a proof of claim against the debtor.

4232.49 A debtor or trustee may file a proof of claim for the creditor if the creditor does not file.

4232.50 Only allowed claims share in the distribution of the debtor's assets.

4232.51 Only unsecured creditors must file a proof of claim to recover.

4232.52 Secured creditors are not required to file a proof of claim. However, to the extent the claim exceeds the value of the collateral securing the claim, the creditor is treated as an unsecured creditor. A proof of claim must be filed in order to recover any of this amount.

4232.53 Any interested party can object to a filed claim. If an objection is made, a court hearing is held to decide the amount or the validity of the claim.

4232.54 The following are disallowed claims that are not paid through the bankruptcy proceeding:

- **a.** Unmatured interest
- **b.** Claims already offset by a receivable by the creditor (this prevents double payment)
- **c.** Tax due on property where the tax exceeds the value of the property (in this case, the property is forfeited)
- **d.** Excess charges for services by an insider or attorney of the debtor
- **e.** Alimony and child support not yet due—the debtor still owes these even after the discharge in bankruptcy
- **f.** Claims by a lessor for a broken lease that exceeds the larger of either of the following:
  - (1) One year's rent
  - (2) 15% of total lease payments, but not more than three years' rent
- **g.** Claims by employees for a broken employment contract that exceeded one year after filing

Priority in Distribution to Secured and Unsecured Creditors

4232.55 The claim of a secured creditor to the debtor's property has priority to the claims of all unsecured creditors.

4232.56 The secured creditor has three choices to satisfy the debt that is owed:

1. Accept the collateral as full payment of the debt.

2. Foreclose on the collateral and apply the proceeds from sale of the property to offset the debt.

3. Allow the trustee to dispose of the collateral and remit the proceeds from the sale of the property to the secured creditor.

4232.57 The secured creditor generally may also recover any reasonable fees and costs that result from the debtor's default on the secured debt.

4232.58 Any part of the value of the collateral that exceeds the secured interest is available to satisfy claims of unsecured creditors.

4232.59 If the value of the collateral is less than the amount of the secured debt, the secured creditor can file a proof of claim for this deficiency. The secured creditor is considered an unsecured creditor as to this amount.

4232.60 The priority in distribution to unsecured creditors is as follows:

- **a.** Administrative expenses, court costs, and fees
- **b.** Debts owed for domestic support obligations (alimony, maintenance, child support)
- **c.** Unsecured debts incurred during the involuntary gap (between filing of involuntary suit and order for relief and trustee appointment) arising in the ordinary course of the debtor's business
- **d.** Wages, salaries, or commissions earned within 180 days of filing, up to $15,150 for each individual
- **e.** Contributions to employee benefit plans for services within 180 days of filing. Cannot exceed $15,150 times the number of employees. This amount is reduced by the aggregate amount paid to employees for wages, salaries, or commissions (see item *d.* above) and by the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.
- **f.** Certain unsecured claims of persons engaged in the production of grain or engaged as U.S. fishermen to the extent of $7,475 for each individual
- **g.** Deposits of money by individuals with the debtor for purchase or rental of property or personal services for personal or household use up to $3,350 each (like a layaway plan or security deposit)
- **h.** Federal, state, or local taxes (like income taxes, property taxes, or withholding taxes)
- **i.** Allowed unsecured claims based upon any commitments by the debtor to a federal depository institution's regulatory agency
- **j.** Claims for death or personal injury resulting from operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

Bankruptcy Plan

4232.61 A plan is required in bankruptcy Chapters 9, 11, and 13.

4232.62 The plan can specify the following:

- **a.** How much creditors will be paid (may be partial or full)

b. In what form creditors will be paid

c. Other necessary details

4232.63 During the repayment period, the debtor is protected from creditor pressure.

4232.64 The plan often classifies claims and interest into classes.

4232.65 The plan must consider all classes and treat all members of a class equally.

4232.66 The plan must be confirmed by the court. The debtor, trustee, creditors, SEC (Securities and Exchange Commission), and others may raise objections.

Debts Not Discharged by Bankruptcy

4232.67 The following are among the debts not discharged by bankruptcy:

a. Taxes

b. A debt obtained by false representation

c. Debts not listed on the schedule of debts submitted by the debtor

d. Obligations resulting from breach of fiduciary duty

e. Judgments for embezzlement or larceny

f. Debts owed for alimony or child support

g. Judgments for intentional injury by the debtor to a person or property of another (called intentional torts)

h. Amounts for fines and penalties due to a governmental unit

i. Amounts owed on educational loans unless this would impose an undue hardship on the debtor and the debtor's dependents

j. Debts that survived a previous bankruptcy

k. Consumer debt owed to a single creditor of more than $800 for "luxury goods or services" incurred by an individual debtor on or within 90 days before the filing of the bankruptcy petition (luxury goods or services do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor)

l. Cash advances of more than $1,100 that are extensions of consumer credit under an open-end credit plan (as defined in the Consumer Credit Protection Act) that are obtained on or within 70 days before the filing of the bankruptcy petition

m. Amounts owed for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

n. Fines or penalties imposed under federal election law

Insolvency

4232.68 Insolvency is the inability of an individual or company to meet its financial obligations as the debts become due. In other words, the individual's or company's debt exceeds the assets owned. Insolvency proceedings may be started in order to liquidate assets to pay off the outstanding debt.

4232.69 Assets would include, but not be limited to, assets considered collateral, interest in pension plans, and retirement accounts. Liabilities include, but are not limited to, recourse debt and nonrecourse debt that is not in excess of the fair market value of the property that is security for the debt.

4232.70 The taxpayer's insolvency is measured by how much the liabilities exceed the fair market value of the assets right before the discharge.

4233 Secured Transactions

4233.01 A *secured transaction* is a transaction in which the debtor gives to the creditor an interest in specific personal property to secure the payment of the debt. If the debt is not paid, the creditor can sell the personal property and apply the proceeds to the unpaid debt. This is faster and cheaper than suing the debtor, getting a judgment, locating property owned by the debtor, seizing the property, and having it sold at public auction to satisfy the debt. The real property equivalent of a secured transaction is a mortgage (called a "deed of trust" in some states). The secured transaction also gives the creditor a priority over other creditors of the debtor in the personal property used to secure the debt.

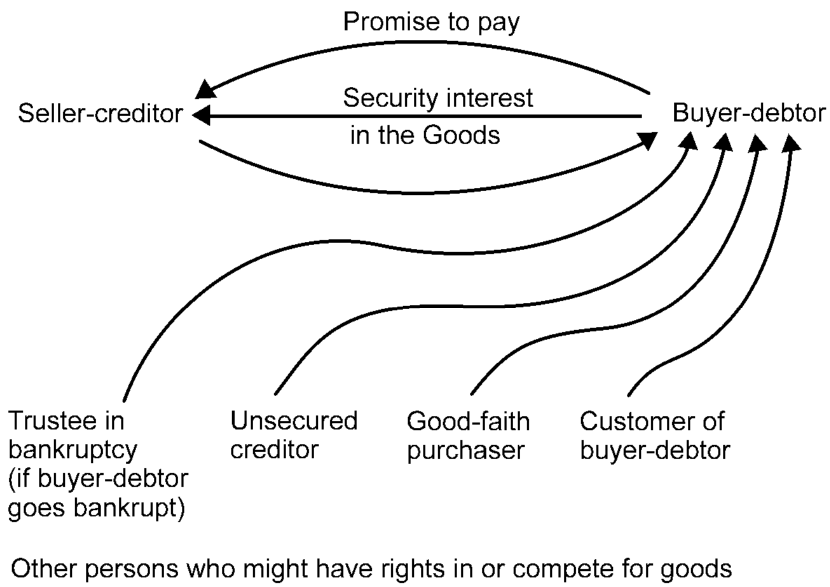
4233.02 The *secured party* is the lender, seller, or other party in whose favor the security interest arises (i.e., the creditor).

4233.03 The *debtor* is the party that owes payment or other performance of the obligation that is secured.

4233.04 The law of secured transactions comes from Article 9 of the Uniform Commercial Code (UCC). A revised Article 9 has been adopted by all of the states and is the basis for the following discussion. Revised Article 9 applies to transactions that create a security interest in tangible or intangible personal property or fixtures. A fixture is personal property that is attached to real property. A central air conditioning unit that is installed in a house would be an example of a fixture.

4233.05 A *security interest* is an interest in personal property or fixtures that secures payment or performance of an obligation.

4233.06 *A security agreement* is an agreement between the debtor and secured party that the secured party shall have an interest in the debtor's property to secure payments or performance of an obligation. It creates the security interest. It may be oral or written (but beware of oral agreements because there is the question of proof).



4233.07 **Requirements of a written security agreement are as follows:**

- **a.** It must be "authenticated" by the debtor. This can include traditional signatures as well as "signatures" that are not handwritten on paper. This facilitates the use of electronic security agreements.
- **b.** It must reasonably identify the collateral. Generally, Article 9 types of property (i.e., "inventory," "accounts") can be used to identify the collateral.

4233.08 The agreement must be in writing to be enforced against the debtor and certain third parties unless the secured party has taken possession of the collateral pursuant to an agreement. (See section **4233.06** regarding oral security agreements.) The agreement must be made so that the person will have possession for purposes of security.

Attachment of a Security Interest

4233.09 **Attachment:** Creation; coming into existence of a security interest. In order for a security interest to be legally enforceable, it must attach to particular collateral.

4233.10 Before a security interest attaches, the following must occur:

- **a.** There must be a security agreement (oral or written) between the debtor and the secured party.
- **b.** The secured party must give value.
- **c.** The debtor must have rights in the collateral.

4233.11 The security interest cannot attach until the secured party gives value. Value is generally any consideration that would support a contract. Value also includes any security for preexisting obligations or any binding commitment to extend credit in the future (future advances).

4233.12 The debtor has no rights in an account until the account comes into existence, a contract until the contract is made, timber until the trees are cut, minerals until extracted from the ground, crops until the crops are planted, and fish until the fish are caught.

4233.13 Attachment establishes the creditor as having superior rights against the debtor, but attachment alone does not establish superior rights against a trustee in bankruptcy, unsecured creditors, other secured creditors, and good-faith purchasers from the buyer.

Classifications of Collateral

4233.14 **Collateral:** Property that is subject to a security interest.

4233.15 Revised UCC Article 9 covers security interests that are created in personal property. Personal property includes that which is both tangible and intangible.

4233.16 **Tangible property:** Goods; these are classified by use. The rules applied may vary based on the category involved.

- **a.** **Consumer goods:** For personal use and consumption, like buying a refrigerator for your home.
- **b.** **Equipment:** For business (profit or nonprofit) use. This is also the default classification if you cannot classify it anywhere else. An example would be a doctor buying a refrigerator to use in his office to store medicine.
- **c.** **Farm products:** Used by a debtor engaged in farming as an occupation. An example would be a farmer buying a refrigerator to keep eggs cold before he sells them to a supermarket.
- **d.** **Inventory:** Goods held for sale or lease. This includes raw materials, work-in-progress, finished goods inventory, and supplies. An example would be refrigerators held by an appliance dealer for sale to consumers.

Note that a refrigerator could be any one of the four classifications, depending on its use.

4233.17 Software “embedded” in goods so that it becomes “part of the goods” is treated as goods. If software is not “embedded” in a good it is considered a general intangible.

4233.18 **Intangible personal property:** No physical existence; a right to receive property. Classifications are as follows:

- **a.** **Instruments:** Negotiable instruments or investment securities. Examples would be checks, drafts, promissory notes, certificates of deposit, bonds, and shares of stock.
- **b.** **Document of title:** A document of title issued by or addressed to a bailee or covering goods in the bailee’s possession. Examples are a bill of lading and a warehouse receipt.
- **c.** **Chattel paper:** Writing that evidences both a monetary obligation and a security in or lease of specific goods. An example would be a security agreement. A security agreement held by a creditor could be used to secure a debt owed to another creditor.
- **d.** **Accounts:** Right to receive payment for goods sold or leased not evidenced by an instrument or chattel paper. The account does not need to be due and payable. Accounts also include payment obligations arising out of the sale, lease, or license of all kinds of tangible and intangible personal property (i.e., license fees payable for use of software). Also included are credit card receivables.

e. **Contract right:** Right to payment under a contract not yet earned by performance nor evidenced by an instrument or chattel paper. These are potential accounts.

f. **General intangibles:** Whatever is not otherwise classified. Examples are goodwill, literary rights, right to performance from someone else, copyrights, trademarks, and patents.

Financing Statement

4233.19 A financing statement is filed to give public notice of the security interest. It provides constructive notice of the security interest. Third parties are deemed to know it exists even if they do not have actual knowledge.

4233.20 A financing statement must contain the following:

a. Names and addresses of both the secured party and the debtor. If an incorrect name of the debtor is used, the financing statement is ineffective, if a "standard" search would not find it.

b. Description of the collateral (If the collateral is a fixture, it must also include a description of the real estate to which the fixture is attached.)

c. Under Revised UCC Article 9, signature of the debtor is not required if the secured party is authorized by the debtor to make the filing without the debtor's signature. This facilitates electronic filing of financing statements.

4233.21 Location of filing of a financing statement:

a. Statewide only (generally the Secretary of State's office)

b. The filing must be in the place of the debtor's "location" except for fixed time filings and filings to perfect a security interest in as-extracted collateral and timber to be cut. Location is defined as follows:

(1) For "registered organizations" created by filing with a state, the state of filing

(2) For an entity not created by a filing, the entity's location is its chief executive offices.

(3) For an individual, the place of their principal residence

c. Perfection of an agricultural lien on farm products occurs by filing centrally in the jurisdiction where the farm products are located. A fixture filing is made locally where the real estate is located.

4233.22 A filed financing statement is effective for five years.

a. After five years, the security interest becomes unperfected. Creditor clients should be reminded of the five-year period as necessary.

b. It can be continued if a continuation statement is filed. It would be good for five more years. This can be done indefinitely.

4233.23 A financing statement generally need not be filed for property subject to a state certificate of title laws. In these cases, the security interest must be noted on the title for the secured party to be protected. This rule would apply, for example, to cars, boats, and mobile homes.

Perfection of a Security Interest

4233.24 The security agreement *binds* the debtor and the secured party from the moment it is made. Generally, however, it does not *protect* the secured party against the rights of third parties until it is perfected.

4233.25 Perfection of a security interest can occur in various ways, but *both* attachment and perfection of the security interest must occur before the interest is good against other creditors.

4233.26 Perfection of a security interest can occur by taking the collateral into possession, public filing of a financing statement, or by attachment alone to make the security interest effective against third parties.

4233.27 **Perfection of a security interest for accounts, contract rights, and general intangibles:** Perfection by filing only

4233.28 **Perfection of a security interest for goods:** Perfection by taking possession or filing a financial statement. No filing is needed if the secured party has possession of the collateral goods.

4233.29 **Perfection of a security interest for consumer goods:** The security interest is automatically perfected upon attachment if the purchaser buys on credit or the secured party lends to the debtor the funds that are used to make the purchase. The security interest is called a purchase money security interest (PMSI); however, this perfection by attachment is not good against a buyer of consumer goods who does any of the following:

a. Purchases without knowledge of the security interest

b. Gives value for the goods

c. Purchases for their own personal family or household use

d. Purchases before a financing statement is filed

Note: This buyer is an individual who bought the consumer goods from the original purchaser.

4233.30 **Perfection of a security interest for instruments, documents and chattel paper:** Perfection by possession or filing

4233.31 **Perfection of a security interest for fixtures:** Perfection only by filing a financing statement with the office where mortgages on real estate are recorded

4233.32 A security interest in instruments and negotiable documents is perfected by attachment alone for 21 days without filing or possession.

Rights and Duties of the Parties

4233.33 A secured party with possession of the collateral must exercise reasonable care in preserving the collateral. Legally, the secured party is a bailee in a mutual benefit bailment.

4233.34 Expenses incurred in the custody, preservation, and operating of the collateral are paid by the debtor.

4233.35 Risk of loss is with the debtor.

Priorities Among Conflicting Security Interests

4233.36 The issue of priority is important when several creditors claim interests in the same collateral.

4233.37 Where multiple security interests exist in the same collateral, the security interests rank in priority according to the time of filing of financing statements or perfection, whichever is earlier.

4233.38 If no security interests have been perfected, the interests have priority based upon the order in which they attached to the collateral.

4233.39 The holder of a purchase money security interest (PMSI) in inventory of the debtor has priority over another secured party who has a prior security agreement with the debtor that contains an "after acquired property clause" covering the debtor's inventory if either of the following is true:

a. The PMSI is perfected by filing at the time the debtor receives the inventory.

b. The PMSI secured party gives written notice to the prior secured party before the debtor gets possession of the inventory.

4233.40 The holder of a PMSI in collateral other than inventory has priority over conflicting security interests in the same collateral if the PMSI is perfected either:

a. at the time the debtor receives the collateral or

b. within 20 days.

4233.41 A buyer in the ordinary course of business from a merchant seller takes free of any security interest in the property purchased even if it is perfected and the buyer is aware of it. The purpose of this rule is to allow a consumer to buy a merchant's inventory without fear that it could be repossessed by the secured party.

4233.42 Artisans' liens have priority over any perfected security interests in the collateral.

Default

4233.43 Default is not defined in the Uniform Commercial Code (UCC). The debtor and secured party are therefore able, by agreement, to define what constitutes a default in their particular case.

4233.44 The secured party may take possession of the collateral either by judicial process or without judicial process if it can be done without a breach of the peace.

4233.45 Generally, the secured party can retain the collateral in satisfaction of the debtor's obligation. Written notice of the intention to keep the collateral must be sent to the debtor and also (except for consumer goods) to any other secured party from whom written notice of a claim in the collateral is received.

4233.46 If no objection to the secured party keeping the collateral is received within 21 days, the collateral may be retained. If objection is made, the secured party must sell the collateral.

4233.47 The secured party must dispose of the collateral if the collateral is classified as consumer goods and the debtor has paid 60% or more of the purchase price. The secured party must sell the consumer goods within 90 days or be liable to the debtor.

4233.48 If the collateral is sold, the proceeds of the sale go to pay the expenses of the sale, then to satisfy the unpaid debt, then to any other debts owed by the debtor to the creditor. Any amount remaining is returned to the debtor. If there is a deficiency, the debtor can be held liable for this amount.

Types of Liens

4233.49 **Floating lien.** This type of security interest is valid. This is often referred to as an "after acquired property clause."

4233.50 An example of a floating lien would be a security interest in the inventory of a new car dealer. The dealer sells cars daily and gets new shipments from the factory weekly. The security interest would float from the cars sold to the new cars coming into the dealer's inventory.

4233.51 A *common law lien* is given to artisans, innkeepers, and common carriers to secure payment for services rendered.

4233.52 Contractors who provide labor or materials that improve real property can establish a mechanic's lien on the improved property for the unpaid balance.

4233.53 Possessory: The lienholder has the right to keep the property until the debt is paid.

4233.54 The lien is lost if possession of the property is surrendered.

4233.55 If the lien is lost, the lienholder cannot retake possession, but he/she can sue the debtor for the value of the service.

4233.56 A *statutory lien* is a lien on personal property created by a statute enacted by the legislature.

4233.57 If the lien was not recognized at common law, the courts construe the language of the statute strictly.

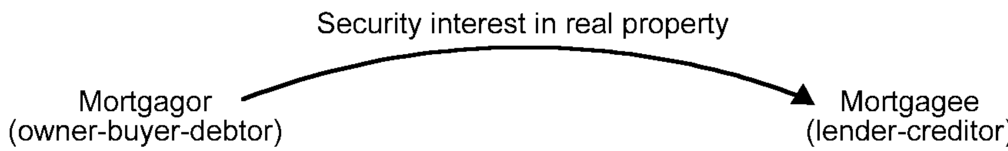
4233.58 **Simplifies the foreclosure.** The creditor holds the property for the statutory period, notifies the person, and then sells the property for whatever they can get. There is no need to get judgment, levy on the property, and have the property sold at public auction by the sheriff. This is expensive and not worth the effort for many low-cost items.

Mortgages

4233.59 A mortgage is a nonpossessory lien on real property to secure payment of a debt.

4233.60 A mortgage is security for a debt. The debt is usually for the unpaid purchase price on the real property, but the mortgage can be used as security for any debt or obligation.

4233.61 Diagram of a mortgage:



4233.62 A mortgage is executed with the same formality as a deed. Because it is an interest in real property, the statute of frauds requires that mortgages must be in writing. Oral mortgages are not enforceable.

4233.63 A person cannot issue a mortgage unless the person owns the property. A mortgage can be issued to cover property acquired in the future.

4233.64 The first recorded mortgage has priority over later recorded mortgages. Tax liens and mechanic's liens on property have priority over mortgages.

4233.65 Mortgages should be recorded to give other parties notice. An unrecorded mortgage has no effect on a subsequent third-party purchaser. An unrecorded mortgage is only effective as between the mortgagor and the mortgagee.

4233.66 The mortgage is recorded in the county where the real property is located.

4240 Federal Laws and Regulations (e.g., Employment Tax, Qualified Health Plans, Bankruptcy, Worker Classifications, and Anti-Bribery)

Social Security (FICA)

4240.01 Social Security is a federal law administered by the Social Security Administration under the Department of Health and Human Services (DHHS). It is also called FICA (Federal Insurance Contributions Act).

4240.02 **Historical development of Social Security (FICA)**

1935—Law passed. Covered only retired workers in industry and commerce.

1939—Paid survivors when worker died.

1950—Coverage extended to self-employed persons, state and local government employees, household and farm workers, members of the armed forces, and members of the clergy.

1954—Disability insurance added to cover a worker who was totally disabled.

1965—Medicare added. Hospital and medical insurance to persons aged 65 and older.

1972—Benefits go up automatically as cost of living goes up.

1973—Medicare coverage expanded to cover people under the age of 65 who are disabled for two years and people with permanent kidney failure who need dialysis or kidney transplants.

1983—Medicare coverage expanded to federal employees.

1984—Employers paid more than employees for one year only. Coverage extended to all newly hired federal employees plus all current and future members of Congress, the president and vice president, all sitting federal judges, magistrates, bankruptcy judges and referees in bankruptcy, and all executive level and senior executive service political appointees. Other current federal employees at the time could elect coverage under Social Security.

1990—Self-employed persons paid the same combined amount as an employee and employer.

1991—Social Security (OASDI—Old Age, Survivors, and Disability Insurance) and Medicare (HI—Hospital Insurance) separated and became subject to different maximums.

1994—Maximum income limit removed from the Medicare portion of the payment.

2000—Retirement age for those born after 1937 is gradually extended, eventually to the age of 67.

4240.03 Major programs of Social Security (FICA) (under which payments are received)

a. Retirement

(1) At age 62 with reduced payments

(2) At age 66 with regular payments

b. Disability before age 65

(1) The individual must have a physical or mental condition that keeps the person from working, which is expected to last 12 months or result in death.

(2) Payments start for sixth full month of the disability.

c. Survivors of deceased worker

Those who may receive payments include the following:

(1) Unmarried child under the age of 18

(2) Unmarried child under the age of 19 if a full-time student in primary or high school, but *not* college

(3) Surviving spouse aged 60 or older

(4) Surviving spouse or divorced parent who takes care of the deceased's children under 16 years of age

(5) Dependent parents aged 62 or older

(6) Divorced spouse if marriage lasted 10 years

d. Retired or disabled workers

Those who may receive payments include the following:

(1) Unmarried child under the age of 18

(2) Unmarried child under the age of 22 if a full-time student

(3) Surviving spouse aged 62 or older

(4) Wife under the age of 62 if taking care of child(ren) under the age of 18

e. Medicare

(1) Hospital insurance and medical insurance for the following:

(a) Individuals aged 65 and older

(b) Disabled individuals under the age of 65 who are entitled to Social Security disability benefits

(c) Workers and dependents who need dialysis treatment or a kidney transplant because of permanent kidney failure

(2) Hospital insurance covers cost of inpatient hospital care.

(a) No cost to the individual

(b) Covered automatically

(3) Medical insurance covers cost of physicians, outpatient hospital care, and other medical expenses.

(a) Medical insurance requires a monthly premium.

(b) The premium covers about 30% of the actual cost. The remainder comes from general revenues of the federal government.

f. Supplemental Security Income (SSI)

(1) Additional income to help the aged, blind, and disabled person

(2) Financed from general revenues (not a special trust fund)

(3) Monthly payments are received by the eligible individuals.

(4) The individual must have little or no regular cash income and no substantial assets that can be sold for cash (excludes house and household goods).

(5) An individual can get both Social Security and SSI if eligible for both.

4240.04 Contribution rates and amounts

a. Starting in 1991, the Old Age, Survivors, and Disability Insurance (OASDI), commonly referred to as Social Security, and Medicare Hospital Insurance (HI), commonly referred to as Medicare, components were separated and different maximum wage bases were applied.

b. If an individual works for two employers, each is required to withhold up to the maximum. If the employee’s combined income exceeds the maximum income amount, the FICA tax withheld will exceed the maximum employee tax for the year. If this occurs, the excess FICA tax paid is claimed as a credit on the individual’s income tax return.

c. The maximum amount of salary and wages that is taxable automatically increases based on a formula that uses national average wage index ratios.

d. The employer portion of the FICA tax is deductible as an ordinary and necessary business expense by the employer.

e. The following summarizes the Social Security (OASDI) and Medicare (HI) program rates, limits and key facts for 2023:

Old Age, Survivors, and Disability Insurance (OASDI)	
Tax rates	
Social Security (Old-Age, Survivors, and Disability Insurance)	
Employers and employees, each[a]	6.20%
Medicare (hospital insurance)	
Employers and employees, each[a, b]	1.45%
Maximum taxable earnings	
Social Security	$160,200
Medicare (hospital insurance)	No limit
Full retirement age	67
Cost-of-living adjustment - 2023	8.7%

[a] *Self-employed persons pay double the rate for a total of 15.3%: 12.4% for Social Security and 2.9% for Medicare. This is because they pay the employee's portion and the employer's portion as a self-employed person.*

[b] *This rate does not reflect the additional 0.9% in Medicare taxes certain high-income taxpayers are required to pay.*

4240.05 Social Security (FICA) compensation:

a. Includes earnings from wages and salary

b. Includes vacation pay and dismissal pay

c. Includes bonuses, commissions, and prizes

d. Does not include expenses reimbursed

e. Does not include fringe benefits paid by employer (like hospitalization, group life insurance, and pension payments)

f. If an employer pays the employee's share of FICA, the employer must include the amount of taxes that they pay in the employee's gross wages for income tax purposes (gross wages) but does not count them as Medicare or Social Security wages.

4240.06 Employees subject to the withholding:

a. Includes corporate officers

b. Includes domestic workers (maids and babysitters) making at least $50 per quarter

c. Need not include spouse and minor children of the employer

d. Does not include independent contractors (they pay as self-employed persons)

4240.07 Federal employees hired after 1983 are covered by Social Security.

4240.08 State employees

a. State employees as a group can elect to be covered by Social Security.

b. Some states have recently decided to get out of Social Security.

4240.09 Social Security benefits have been taxable in certain cases since 1984 based on the amount of the individual's modified adjusted gross income.

4240.10 **Social Security Trust Fund:**

a. The Social Security Trust Fund is the accumulation of receipts less benefits.

b. The fund currently has a surplus that will continue to grow, then gradually decrease as post-World War II baby boom persons reach retirement age and start receiving their Social Security benefits.

c. The fund can be used to pay other government bills but will likely be dedicated only to Social Security benefits.

4240.11 **Retirement age for full benefits:** For people born in 1943 through 1954, the full retirement age is 66. The full retirement age increases gradually each year until it reaches age 67 for people born in 1960 or later. Earned income includes:

a. wages, salaries, tips, and other taxable employee pay,

b. union strike benefits,

c. long-term disability benefits received prior to minimum retirement age, and

d. net earnings from self-employment if:

(1) you own or operate a business or a farm,

(2) you are a minister or member of a religious order, or

(3) you are a statutory employee and have income.

Legal Liability for Payroll and Social Security Taxes

4240.12 Along with the Social Security tax, an employer is generally required to withhold income tax on each payment of wages made to an employee.

4240.13 An employer who is subject to either Social Security taxes or income tax withholding, or both, is required to file a quarterly return on IRS Form 941. This quarterly form combines the reporting of FICA and income taxes withheld from employees' wages.

4240.14 Generally, an employer is required to deposit the FICA taxes and income taxes withheld at an authorized commercial bank depository.

4240.15 Generally, an employer is classified as either a monthly or semiweekly depositor. The status for a particular calendar year is decided annually, based on the employment tax reporting history for a 12-month lookback period ending on June 30 of the prior year. The IRS notifies employers by November of each year as to their classification for the next calendar year. The classification is based on the aggregate amount of employment taxes reported during the lookback period.

4240.16 In spite of the above rule, an employer with $100,000 or more of accumulated liability during a monthly or semi-weekly period is required to deposit the taxes by the first banking day after the $100,000 amount is reached.

4240.17 Employers that have less than $2,500 of liability during the quarter are not required to deposit the taxes. Instead, they send the full payment for the quarter with their quarterly IRS Form 941.

4240.18 Employers that fail to deposit the full amount of taxes due are not subject to penalty if the shortfall does not exceed the greater of $100 or 2% of the amount of employment taxes due. This is true provided the shortfall is deposited on or before a prescribed makeup date.

4240.19 An employer also will not be subject to a penalty if they can show that the failure to deposit was due to reasonable cause (IRC Section 6656).

4240.20 A multi-tier penalty structure generally applies to situations where the employer fails to make timely deposits of employment taxes. The penalty is as follows:

- **a.** 2% of the amount of the underpayment if the failure is for no more than 5 days
- **b.** 5% of the amount of the underpayment if the failure is for more than 5 days but for no more than 15 days
- **c.** 10% of the amount of the underpayment if the failure is for more than 15 days
- **d.** 15% of the amount of the underpayment if a required tax deposit is not made on or before the day that is 10 days after the date of the first delinquency notice to the employer

4240.21 Under IRC Section 6672, any responsible person (usually a corporate officer or employee) who willfully fails to withhold, account for, or pay over withholding tax is liable for a penalty equal to 100% of such tax. Generally, the IRS only assesses this penalty in situations where the employment taxes cannot be collected from the employer. In addition, every taxpayer must be identified by a taxpayer identifying number (Social Security numbers (SSNs) or employer identification numbers (EINs)). This identifying number must be included on every required tax paper filed: every tax return, declaration of estimated tax, information return, and other necessary information. It must also be furnished on request to every employer and everyone else who pays to the taxpayer income required to be reported on an information return.

Federal Unemployment Tax Act (FUTA)

4240.22 The Federal Unemployment Tax Act (FUTA) is also known as unemployment compensation tax.

4240.23 FUTA's purpose is to provide economic security for temporarily unemployed workers. Only employers pay FUTA, and it is deductible as an ordinary and necessary business expense of the employer.

4240.24 An employer is obligated to pay FUTA taxes if the employer:

- **a.** paid wages of $1,500 or more in any calendar quarter or
- **b.** had one or more employees for any 20 calendar weeks during the year.

4240.25 An employer is obligated to pay FUTA taxes if the employer paid total cash wages of $1,000 or more to any household employee in any calendar quarter. A household employee is an individual who performs household work in a private home, local college club, or local fraternity or sorority chapter.

4240.26 FUTA must be paid if farmworkers received cash wages of $20,000 or more during any calendar quarter or employed 10 or more farmworkers during at least some part of a day (whether or not at the same time) during any 20 or more different weeks.

4240.27 For 2023, the FUTA tax rate is 6.0%. The tax applies to the first $7,000 paid to each employee as wages during the year.

4240.28 Employers can take a credit against their FUTA tax for amounts paid into state unemployment funds. Employers may take the maximum credit if they paid their state unemployment taxes in full, on time, and on all the same wages as are subject to FUTA tax, and as long as the state is not determined to be a credit reduction state.

4240.29 Administration and enforcement of FUTA are under the jurisdiction of the Social Security Administration.

4240.30 The federal taxes are paid to the United States Treasury.

4240.31 Willful failure to pay, file returns, or keep records is a misdemeanor and subject to a fine, imprisonment of not more than one year, or both. There are civil penalties of an additional tax for late filing and liability for double the tax amount.

Affordable Care Act

4240.32 **Individual mandate:** Under the Patient Protection and Affordable Care Act (ACA), U.S. citizens and legal residents who do not qualify for an exemption are required to purchase a minimum of health care coverage through health care exchanges. The penalty for violating the individual mandate clause is $0. For those who cannot afford health insurance at any price, the federal government has established financial assistance programs to assist in offsetting the cost of the mandated insurance.

4240.33 **Employer requirements:** Under certain conditions, employers with 50 or more full-time employees that do not offer coverage are assessed a monthly prorated penalty of $2,880 per full-time employee for 2023, excluding the first 30 employees from the assessment. Employers with 50 or more full-time employees that offer coverage but have at least one full-time employee receiving a premium tax credit pay the lesser of $4,320 for each employee receiving a premium credit or the monthly penalty that would apply for each full-time employee if no coverage was offered, excluding the first 30 employees from the assessment. Employers with more than 200 employees must automatically enroll employees into health insurance plans offered by the employer (employees may opt out of coverage).

4240.34 Under the ACA, employer-sponsored health care coverage must conform to certain standards:

- **a.** Free preventive care (for example, routine physicals)
- **b.** Caps on co-payments
- **c.** Insurers cannot increase premiums for those more likely to use medical services; for example, due to age, gender, or preexisting conditions.
- **d.** Cover at least 95% of full-time employees
- **e.** To be classified as affordable, it must cost no more than 9.61% of an employee’s salary.

4240.35 There are 10 essential benefits under the ACA:

1. Prescription medication
2. Emergency services
3. Hospitalization and surgery

4. Laboratory services
5. Mental health services
6. Outpatient care
7. Pediatric care
8. Pre- and postnatal care
9. Preventive care (for example, checkups)
10. Rehabilitative care

4240.36 Premium tax credits (often referred to as PTCs) are available to exchange enrollees if their income is between 100% and 400% of the federal poverty level. Medicaid is available to enrollees with incomes up to 138% of the poverty level in those states that have expanded Medicaid under the ACA.

4240.37 Medicaid is expanded to all non-Medicare eligible individuals under age 65 (children, pregnant women, parents, and adults without dependent children) with incomes up to 138% FPL (federal poverty level) based on modified adjusted gross income. All newly eligible adults are guaranteed a benchmark benefit package that meets the essential health benefits available through the health care exchanges. The Supreme Court has ruled that states can opt out of Medicaid expansion.

4240.38 Businesses with fewer than 50 full-time employees do not have to insure the employees. Small employers with no more than 25 employees and average annual wages of less than $50,000 that purchase health insurance for employees are provided a tax credit.

4240.39 The ACA includes a number of changes related to health insurance. These changes:

- **a.** exclude the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement arrangement (HRA) or health flexible spending account (FSA) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer medical savings account (MSA).
- **b.** increase the tax on distributions from a health savings account or an Archer MSA that is not used for qualified medical expenses to 20% (from 10% for HSAs and from 15% for Archer MSAs) of the disbursed amount.
- **c.** limit the amount of contributions to a flexible spending account for medical expenses to $2,500 per year increased annually by the cost-of-living adjustment ($3,050 for 2023).
- **d.** limit the threshold for the itemized deduction for unreimbursed medical expenses to 10% of AGI for regular tax purposes (this was changed to 7.5% beginning in 2020).
- **e.** limit the Medicare Part A (hospital insurance) tax rate on wages to 2.35% on earnings over $200,000 for individual taxpayers and $250,000 for married couples filing jointly and impose a 3.8% tax on unearned income for higher-income taxpayers (thresholds are not indexed).
- **f.** provide dependent coverage for children up to age 26 for all individual and group policies.

Workers' Compensation

4240.40 Workers' compensation used to be called workmen's compensation. Coverage under these statutes varies from state to state.

4240.41 Problems with the common law tort liability system before workers' compensation

a. Time. Possibly years in the court system before the injured worker could collect.

b. Attorney's contingent fees (often 20%–50%) reduced the dollar amount the injured worker actually received.

c. Defenses available to the defendant employer include the following:

(1) Employee plaintiff assumed a known risk in accepting the job.

(2) Employee plaintiff was contributorily negligent. In some states, a plaintiff cannot collect unless totally fault free. Other states with a comparative negligence allow a percentage recovery based on the comparative fault of the two parties.

(3) Fellow servant rule. If the injury was caused by a fellow employee, the employer is not liable. The negligence of the employee is not imputed to the employer as is the usual case with the doctrine of *respondeat superior.* The injured employee can only sue the fellow employee for the negligence.

4240.42 Purpose of workers' compensation law enacted by the states:

a. To protect employees and their families from the risks of financial loss as a result of accidental injury, death, disease, or disability resulting from employment

b. To correct the problems of the common law tort liability system

c. To provide an employee's exclusive remedy against the employer for covered injuries

4240.43 Employers are strictly liable without fault for injury, death, disability, or disease resulting from employment.

4240.44 Typical statutory exclusions from workers' compensation coverage:

a. Domestic employees (e.g., maids)

b. Agricultural employees

c. Employers having less than some minimum number of employees

4240.45 Two types of workers' compensation statutes:

1. Compulsory law

(a) The employer has no choice—must be covered by workers' compensation law.

(b) Majority of states have a compulsory law.

2. Noncompulsory law

(a) The employer is liable for injury or death resulting from and proximately caused by the employer's negligence if the employer does not elect coverage.

(b) There is no statutory limit on the amount of damages that can be recovered.

(c) The employer may elect to be covered by the workers' compensation law that provides statutory limits.

(d) If the employer does not elect the workers' compensation coverage, the employer loses the usual common law defenses.

4240.46 Ways of providing coverage:

a. Self-insurance

(1) The employer pays all claims directly.

(2) The employer must demonstrate capability to pay claims. Usually only large corporations can do this.

b. Insurance with a private company

(1) Some insurance companies specialize in this type of insurance.

(2) Rate is determined by claim experience and number of employees.

c. Insurance with the state fund

(1) Usually the most expensive way

(2) Rate is based on claim experience and number of employees.

4240.47 Workers' compensation

a. The employer must pay the entire cost. It cannot be deducted from the employee's wages.

b. This was the first form of social insurance in the United States.

c. This was the first "liability without fault" system in the United States.

d. Today all 50 states have workers' compensation systems.

4240.48 New trends

a. Covers diseases as well as injuries as long as they are work related

b. Covers psychological injuries as well as physical injuries

Example: High-pressure job causing an air traffic controller to have a mental breakdown

c. Established by the 1972 report by the 15 members of the presidentially appointed commission on state workmen's compensation laws. Their recommendations were as follows:

(1) Require all states to conform to specific standards as to coverage and benefits.

(2) Cover all employees.

(3) No time or money limits on type, extent, or expense of medical care

(4) Weekly death or total benefits of at least two-thirds of the average weekly wage

(5) Offer rehabilitation services to reduce disability and restore physical, psychological, social, and vocational functioning of injured employees.

(6) Spouse gets death benefits for life or until remarriage.

(7) Children get death benefits until the age of 18, or 25 if a full-time student.

(8) Adjust compensation benefits to reflect increases in wage levels.

4240.49 Employers' reaction to the workers' compensation law has been to reduce the frequency and severity of job-related disabilities to minimize the premium and other expenses.

a. Inspect physical facilities for the following:

(1) Gas

(2) Vapor

(3) Fumes

(4) Dust

(5) Heat

(6) Noise

(7) Lighting

(8) Radiation

(9) Ventilation

(10) Any other dangerous conditions

b. Education programs for loss control include the following:

(1) Accident investigation

(2) Safety rules (e.g., wearing hard hats when there is overhead danger)

(3) Feedback information

4240.50 **Admiralty law.** Under the Jones Act of 1920, injured seamen are entitled to a trial by jury with no limit on awards for occupational injuries. Injured seamen may elect to be covered by the liberal federal law and avoid the state workers' compensation laws. Commercial fishing is also subject to U.S. admiralty law and the Jones Act.

4240.51 Various federal statutes cover other employees, such as railroad workers, longshoremen, and harbor workers, for job-related injuries.

Worker Classification

4240.52 The Fair Labor Standards Act (FLSA) requires that most employees be paid at least the federal minimum wage for all hours worked and time and one-half the regular rate of pay for all hours worked over 40 hours in one workweek. However, the FLSA exempts certain employees from both the minimum wage and overtime pay requirements if they are classified as exempt employees (e.g., executives, administrative positions, professionals, outside sales employees, and certain computer employees). As such, it is imperative that business owners correctly determine whether the individuals providing services are employees or independent contractors.

4240.53 Employee classification under the FLSA refers to the exempt or non-exempt status of employees. An exempt classification generally means the employer is not obligated to pay overtime when the employee works more than 40 hours in a workweek. Conversely, a non-exempt classification means the employee is not exempt from overtime and must be paid overtime when hours worked exceeds 40 in a workweek. While some states differ in overtime laws and regulations, federal regulations use a 40-hour workweek as the measurement.

a. To qualify for an exemption under the FLSA, employees generally must meet certain tests regarding their job duties and be paid on a salary basis at not less than $455 per week. Job titles alone do not determine exempt status. If a business classifies an employee as an independent contractor and with no reasonable basis for doing so, the employer may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply).

b. For workers classified as employees, employers generally withhold income taxes, Social Security, and Medicare taxes, and pay unemployment tax on wages paid to an employee. For independent contractors, these amounts are not withheld; the contractor is responsible for remitting any taxes directly to the state or federal government.

c. The risk in misclassifying employees does not lie in classifying employees as non-exempt; rather, it rests with classifying as exempt. Because an exempt classification generally removes the employee's right to receive overtime pay for hours worked over 40 in a workweek, employers must take care to ensure proper classification. If misclassification is discovered by the employee or a regulatory agency, the employer may be responsible for paying the employee back wages plus any applicable penalties and fees. If an employer is faced with a wage and hour claim for overtime owed, it also could result in a full-scale audit encompassing all employees, both active and inactive, over a period of up to three years (or more depending on state law).

4240.54 Businesses should consider the following factors when determining whether a worker is an employee or independent contractor. As no one factor is more important than the other, the key is to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination. Facts that provide evidence of the degree of control and independence fall into three categories:

1. **Behavioral:** Who controls what the worker does and how the worker does his or her job?
2. **Financial:** Who compensates the worker (i.e., how is the worker paid, are expenses reimbursed, who provides tools/supplies, etc.)?
3. **Type of relationship:** Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, etc.)?

Bribery of Foreign Officials

4240.55 The primary U.S. federal law addressing bribery and corruption of foreign government officials is the Foreign Corrupt Practices Act (FCPA).

a. **The FCPA:** Enacted in 1977, the FCPA prohibits U.S. individuals, businesses, and certain foreign issuers of securities from bribing foreign government officials to obtain or retain business. It applies to companies and their representatives, including lawyers, agents, executives, and employees.

b. **Issuer and domestic concerns:** The FCPA applies to "issuers" (companies listed on U.S. stock exchanges or that are required to file reports with the Securities and Exchange Commission (SEC)) and "domestic concerns" (U.S. residents, nationals, and businesses).

c. **Third parties:** U.S. entities can be held liable for corrupt acts by third parties, like agents or consultants, if they know (or ought to know) that the third party is making illicit payments.

d. **Business purpose test:** The bribe must be in relation to obtaining or retaining business or securing any improper advantage. This includes not only contract awards but also regulatory permits, licenses, or other benefits.

e. **Anything of value:** Bribes are not limited to cash. Gifts, entertainment, or other inducements of value can be seen as bribes.

f. **Accounting provisions:** Apart from anti-bribery, the FCPA has provisions requiring companies to maintain accurate books and records, and to establish adequate internal controls, ensuring that transactions are transparently and accurately recorded.

g. **Facilitation payments:** The FCPA provides a narrow exception for "facilitation payments" for "routine governmental actions." These are small payments to expedite or secure the performance of routine, nondiscretionary actions, like processing paperwork or providing utilities. However, their interpretation can be complex, and many companies choose to prohibit them entirely.

h. **Defenses:** Two main defenses in the FCPA are the following:

   (1) Local law defense: If a payment was lawful under the written laws of the host country

   (2) Reasonable expenditures defense: For expenses, like travel and lodging, related to the promotion, demonstration, or explanation of products or services

i. **Penalties:** Violations can lead to significant civil and criminal penalties, including fines and imprisonment. Fines can sometimes exceed the benefits received from the bribe.

j. **Whistleblower protections:** The SEC's whistleblower provisions can reward those who provide information leading to successful enforcement actions.

k. **Compliance programs:** A robust compliance program can serve as a defense to FCPA charges. It is essential for companies operating internationally to train employees on the FCPA and to continuously monitor and audit their compliance.

l. **Global relevance:** While the FCPA is a U.S. law, many countries have similar laws (like the UK Bribery Act). Multinational companies need to be aware of and compliant with anti-corruption laws in all jurisdictions where they operate.

Discharge of Debtor

4240.56 A discharge can be given to individuals only.

4240.57 Discharge will generally be given unless the individual debtor did any of the following within one year prior to filing or during the bankruptcy proceedings:

a. Destroyed or concealed property in order to defraud creditors

b. Destroyed, falsified, or concealed records

c. Failed to cooperate (lied, withheld information, made false claim)

d. Refused to obey lawful order of court

e. Refused to testify in answering questions approved by the court

Trustee

4240.58 Once the debtor becomes subject to bankruptcy proceedings, the court appoints an interim trustee to take over the debtor's property or business.

4240.59 Shortly, a permanent trustee takes over. Usually, the permanent trustee is elected by the creditors at a creditor's meeting.

4240.60 The trustee is an individual or a corporation who, under court supervision, represents the debtor's estate.

4240.61 The basic duties of the trustee are the following:

- **a.** Investigate the financial affairs of the debtor.
- **b.** Collect the debtor's assets and any claims owed to the debtor.
- **c.** Temporarily operate the debtor's business if necessary.
- **d.** Reduce the debtor's assets to cash.
- **e.** Receive and examine claims of creditors. The trustee will challenge in bankruptcy court any claims that are questionable.
- **f.** Oppose the discharge of the debtor if the trustee feels there are legal reasons why the debtor should not be discharged.
- **g.** Render a detailed accounting to the bankruptcy court of all assets disposed of and received.
- **h.** Make a final report to the bankruptcy court when administration of the debtor's estate is completed.

4240.62 The trustee is paid from the estate.

4240.63 Compensation cannot exceed the following amounts of the debtor's estate under the Bankruptcy Reform Act of 1994.

Amount			Percentage
$ 0	to	$ 5,000	25
$ 5,001	to	$ 50,000	10
$50,001	to	$1,000,000	5
	Over	$1,000,000	3
			(or reasonable compensation if less)

4240.64 The trustee can employ attorneys, accountants, appraisers, and other individuals with prior court approval.

4240.65 The trustee can also sue and be sued as trustee.

Chapter 7 Bankruptcy

4240.66 A Chapter 7 bankruptcy can be voluntary or involuntary.

4240.67 A Chapter 7 bankruptcy has special provisions for stockholders and commodities brokers.

4240.68 A Chapter 7 bankruptcy can apply to a business debtor or a nonbusiness debtor (like an individual).

4240.69 The attorney for the debtor in a Chapter 7 bankruptcy has certain specified obligations, including:

- **a.** filing an affidavit with the bankruptcy court stating that they have informed the debtor of the various forms of bankruptcy and their details and

b. reasonably verifying the information contained in the bankruptcy petition and the supporting schedules.

4240.70 Individual debtors with income below the median for their state of residency can generally receive the protection of a Chapter 7 proceeding. In contrast, an individual debtor with income above the state median income must submit to a means test that measures the extent to which the debtor can repay general unsecured claims.

4240.71 A Chapter 7 case will be dismissed or, with the debtor's consent, converted to a Chapter 13 case if it is found that there is abuse by an individual debtor with primarily consumer debt. Abuse can be found in the following two ways:

1. Abuse can be found due to bad faith or fraud on the part of the debtor.

2. Abuse is presumed if a debtor has sufficient income to pay back a portion of their debts as determined under the means test.

4240.72 Under the Chapter 7 means test, abuse is presumed to exist if net monthly income (current monthly income less the deduction listed below) multiplied by 60 is not less than the lesser of:

a. 25% of the debtor's nonpriority unsecured claims in the case, or $9,075, whichever is greater; or

b. $15,150.

4240.73 In a Chapter 7 bankruptcy, the presumption of abuse can only be rebutted if the debtor presents detailed documentation of "special circumstances." Special circumstances include a debtor having a serious medical condition or being on active duty in the military. These special circumstances must justify adjustments to income or expenses.

4240.74 The debtor's net monthly income is determined by deducting two major categories of expenses:

1. Reasonable living and other expenses allowed in the Internal Revenue Service Financial Analysis Handbook as "necessary expenses" and

2. The following expenses authorized under the Federal Bankruptcy Code:

- **a.** Expenses to maintain the safety of the debtor and the debtor's family from domestic violence
- **b.** Payments to secured creditors that will become due in the five years after filing, divided by 60 (past due payments may be included only if the collateral is necessary for the support of the debtor and the debtor's dependents)
- **c.** Alimony, child support, and other priority claims such as unpaid taxes divided by 60
- **d.** Expenses that are reasonable and necessary for the care and support of an elderly, disabled, or chronically ill family member
- **e.** Actual expenses for grade and high school up to $2,275 per child annually, if the expenses are not covered by applicable IRS standards and the debtor documents that they are reasonable and necessary
- **f.** Actual expenses for household utility services, if the expenses are not covered by the IRS Local Standards and the debtor documents that they are reasonable and necessary

4240.75 In Chapter 7, an interim trustee can be appointed after the case is filed. He or she serves until the regular trustee is elected or designated and is appointed from a panel of private trustees.

4240.76 A Chapter 7 proceeding may be converted (one change only) to Chapter 11 or Chapter 13.

4240.77 The court can order a Chapter 7 bankruptcy case to Chapter 11 (but not Chapter 13).

4240.78 Under current law, a debtor who obtains relief under Chapter 7 must wait eight years before filing under Chapter 7 again.

Chapter 9 Bankruptcy

4240.79 Chapter 9 bankruptcy is available only to municipalities.

4240.80 A Chapter 9 bankruptcy applies only to a municipality that:

- **a.** is insolvent or not able to meet debts as it matures,
- **b.** wants a plan to adjust debts, and
- **c.** has obtained creditor agreement, has negotiated in good faith with creditors but has not reached agreement, or is unable to negotiate with creditors because it is impractical.

4240.81 A Chapter 9 bankruptcy must be voluntary, not involuntary.

4240.82 There is no trustee under a Chapter 9 bankruptcy.

4240.83 For a Chapter 9 bankruptcy, a proof of claim need not be filed by creditors because a list of creditors is required to be filed by the debtor.

4240.84 A municipality cannot liquidate. Chapter 9 bankruptcy allows the city to operate while it adjusts or refinances its creditor claims.

4240.85 A Chapter 9 bankruptcy must end up with an approved plan.

Chapter 11 Bankruptcy

4240.86 A Chapter 11 bankruptcy is used if it is felt continuing the business is preferred to a liquidation.

4240.87 A Chapter 11 bankruptcy applies only to those who could be a debtor under Chapter 7 and railroads.

4240.88 A Chapter 11 bankruptcy can be voluntary or involuntary. The same requirements apply for filing an involuntary petition as in a Chapter 7 proceeding.

4240.89 Chapter 11 contains special provisions for reorganization of railroads.

4240.90 Chapter 11 is primarily for businesses. Individuals can use this Chapter, but it would probably be too burdensome and expensive.

4240.91 In a Chapter 11 bankruptcy, a trustee may or may not be appointed. The debtor may remain in possession of property at the court's discretion. If a trustee is appointed, they take over the business and have the same basic powers as in a liquidation proceeding.

4240.92 Railroads can only be in Chapter 11 reorganization.

4240.93 In a Chapter 11 bankruptcy, a proof of claim need not be filed by creditors because a list of creditors is required to be filed by the debtor.

4240.94 A Chapter 11 bankruptcy may be converted (one conversion only) to Chapter 7.

4240.95 The purpose of a Chapter 11 bankruptcy is to restructure finances so the debtor can continue to operate. It binds nonconsenting creditors, while a common-law composition does not. It would hurt employees and the economy if some large corporations went out of business. Chapter 11 often restructures the debt of a large corporation. Creditors will take less but better that than a large corporation liquidating.

4240.96 A Chapter 11 bankruptcy must end up with an approved plan.

4240.97 When the debtor is an individual, unless the bankruptcy court orders otherwise for cause, confirmation of a Chapter 11 plan does not discharge any debts provided for in the plan until the court grants a discharge on completion of all payments under the plan.

4240.98 If the debtor is an individual, earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor can be used to pay creditors for execution of a Chapter 11 plan.

4240.99 A Chapter 11 bankruptcy plan can divide creditors into classes (for example, claims of employees and bondholders) but all creditors in each class must be treated equally.

4240.100 The court will approve a Chapter 11 reorganization plan if one of the following is true:

a. each class has approved the plan or

b. the court rules that the plan is "fair and equitable" to all classes (even if creditors object to the plan).

4240.101 In a Chapter 11 bankruptcy, if the parties involved cannot produce an acceptable plan or if the plan does not work, the court can dismiss the case or convert it into a liquidation proceeding (Chapter 7).

4240.102 After a Chapter 11 bankruptcy plan is confirmed, the debtor is discharged from those claims not provided for in the plan. Nondischargeable debts are the same in Chapter 11 as in Chapter 7.

Chapter 13 Bankruptcy

4240.103 A Chapter 13 bankruptcy applies only to an individual (or individual and spouse) with regular income who owes unsecured debts of less than $465,275 and secured debts of less than $1,395,875.

4240.104 A Chapter 13 proceeding must be voluntary. The creditors cannot institute an involuntary Chapter 13 bankruptcy.

4240.105 A Chapter 13 bankruptcy can only be used by individuals (not partnerships or corporations). A small sole proprietorship can qualify as an individual if the other requirements are met.

4240.106 A Chapter 13 bankruptcy requires a trustee whose main function is to receive and distribute the debtor's income on a periodic basis.

4240.107 A Chapter 13 bankruptcy may be converted (one conversion only) to Chapter 7.

4240.108 A Chapter 13 bankruptcy must end up with an approved plan.

4240.109 A Chapter 13 bankruptcy plan must do the following:

a. State the portion of the debtor's future income that will be turned over to the trustee for distribution to creditors. In determining the disposable income of the debtor, exclusions are made for numerous items, including up to 15% of the debtor's gross income for charitable contributions and the reasonable cost of health insurance for the debtor and their family.

b. Describe how creditors will be paid.

c. Generally, the plan may not provide for payments over a period that is longer than three years. However, the bankruptcy court for good cause (based on a specified computation of family income) may approve a period that is not longer than five years.

4240.110 A Chapter 13 bankruptcy plan can separate creditors into classes, but creditors in a class must be treated equally.

4240.111 A Chapter 13 bankruptcy plan can provide for partial payment of debts, but must provide for full payment of any claims that are given priority in a Chapter 7 proceeding.

4240.112 A Chapter 13 bankruptcy protects the debtor's credit standing better than Chapter 7 liquidation.

4240.113 The court will confirm a Chapter 13 bankruptcy plan if the following are true:

a. The debtor proposes it in good faith.

b. All secured creditors accept the plan.

4240.114 A hearing on confirmation of a Chapter 13 bankruptcy plan may be held not earlier than 20 days and not later than 45 days after the required creditors meeting. The hearing may be held earlier only if the bankruptcy court determines that it is in the best interests of the creditors and the estate and there is no objection to the earlier date.

4240.115 Unsecured creditors are bound by a Chapter 13 bankruptcy plan if it is confirmed by the court, even if the plan modifies their claims.

4240.116 Any time before or after confirmation of a Chapter 13 plan, the debtor can convert the proceedings to a liquidation case.

4240.117 The court can convert the proceedings of a Chapter 13 bankruptcy to a liquidation case or dismiss the case if the debtor fails to perform according to the plan.

4240.118 In a Chapter 13 bankruptcy, before a debtor can receive a discharge, they must complete a financial management course.

4240.119 A debtor who fully performs a Chapter 13 bankruptcy plan will generally be granted a discharge upon completion. In certain cases, debtors can be discharged even if they do not complete the plan, provided the failure is due to circumstances beyond their control.

4240.120 In a Chapter 13 bankruptcy, discharge can be revoked within one year if it is discovered that the discharge was obtained by fraud.

4250 Business Structure

4251 Selection and Formation of Business Entity and Related Operation and Termination

Partnerships

4251.01 Creation of a partnership

a. No formalities are required; it is a voluntary contractual relationship. A partnership can be created by express agreement or through an implied agreement. A partnership can also generally be created either orally or in writing.

b. Intent governs. It can be by express words (oral or written) or implied by the actions of the parties.

c. Tests of existence:

(1) The sharing of net profits and losses creates a rebuttable presumption that a partnership exists. This presumption can be overcome by showing that profits are being shared for another reason. The following are examples:

(a) Repayment of a debt owed to the other party by way of the transfer of a portion of the profits

(b) Wages or rent owed to another party being paid as a portion of the profits

(c) Annuity to a deceased partner’s spouse (Thus the spouse is *not* a partner simply because the spouse is receiving an annuity payment based on profits.)

(d) Interest on a loan owed to another party being paid as a portion of the profits

(e) Consideration for the sale of goods being paid from the profits

(2) Co-ownership of property—this does not of itself establish that a partnership exists but is a factor courts look at in determining if the relationship between the parties is a partnership.

(3) Joint control and management is another factor considered. Courts often view delegating management responsibilities or giving up control as an exercise of joint control.

4251.02 Partnership by estoppel. This doctrine is used to hold a person liable as a partner to a third party when they either hold themselves out as a partner or consent to the holding out of themselves as a partner. Partnership by estoppel does not actually make a person a partner, but it creates the same legal effect of being a partner. A partnership can only be created by the voluntary agreement between the persons. Therefore a partner by estoppel receives no rights of a true partner (i.e., right to manage, right to profits).

4251.03 Types of partners

- **a. General.** Has a right to manage the partnership business. Has unlimited personal liability to the creditors of the partnership for partnership debts.
- **b. Limited.** Merely an investor in a partnership whose liability is limited to the possible loss of their capital contribution. This limited liability rests upon the fact that the partner does not participate in management of the partnership.
- **c. Nominal (ostensible)/partner by estoppel:** A person who is not in fact a partner but holds himself out as a partner or allows others to hold him out as a partner. In some instances, he may be liable as a partner to third persons who rely on this holding out.

  Example: Brian tells Erin that Kevin is his partner during contract negotiations. Kevin is present at the time and does nothing to indicate that this is untrue. Kevin also tells Erin, "We will be sure to do a first-rate job if you enter this contract." If Erin enters the agreement with Brian, Kevin is liable on the agreement as a partner by estoppel.

4251.04 Partnership agreement

- **a.** A partnership agreement is also sometimes referred to as *articles of partnership* and *articles of co-partnerships.*
- **b.** A formal written agreement creating the partnership relationship is not required, but it is a good idea to prevent disputes between or among the partners.
- **c.** Generally, a partnership agreement can be oral. If any part of the partnership agreement falls under the statute of frauds, however, a writing is needed as a practical matter to make the agreement enforceable.

  Example: Caitlin and Jennifer enter a partnership agreement and specify that the duration of the partnership will last for a period of more than one year (i.e., for two years). For the agreement to be enforceable, a writing is required under the statute of frauds.
- **d.** The Uniform Partnership Act (UPA) fills in the rules regarding the relationship between or among the partners unless the agreement specifies a different rule. Thus, the UPA operates as a gap filler.

4251.05 Ordinary business matters

- **a.** In deciding ordinary business matters, a majority vote of the partners prevails as long as it does not violate any special provisions in the partnership agreement.
- **b.** A tie vote leaves the matter as it was, since this is viewed as a deadlock.

4251.06 Extraordinary matters

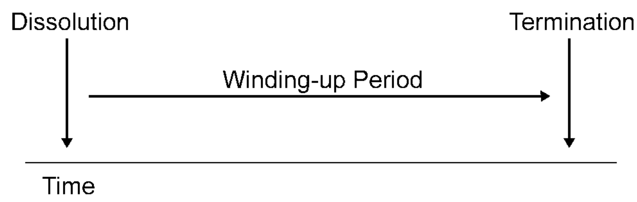
Unanimous agreement of all partners is necessary to make a change involving an extraordinary matter. A majority vote is not sufficient. The decision to go out of business or to change the nature of the partnership business would be examples of extraordinary matters requiring unanimous agreement of all the partners.

4251.07 Ending a partnership

- **a. Dissolution.** This is the point in time when the object of all or any of the partners changes from continuing the organization in its current form to discontinuing it.

b. **Winding up.** Settling partnership affairs after dissolution. No new business can be carried on during the winding-up period. This is the span of time between dissolution and termination.

c. **Termination.** End of the winding-up period



4251.08 Causes of dissolution

a. **Without violation of the partnership agreement**

(1) The agreed time limit of the partnership ends.

(2) The agreed partnership purpose has been completed.

(3) A partner quits a partnership that has no stated duration. This type of partnership is called a partnership at will. The withdrawing partner has no liability to the other partners since they may withdraw at any time.

(4) A mutual agreement of all partners may terminate the partnership.

b. **In violation of agreement.** Any partner may dissolve a partnership at any time, but that partner may be liable for damages. The partner has the power, but may not have the right, to dissolve the partnership.

Example: Caitlin and Erin form a partnership and agree that the partnership will have a duration of five years. After one year a dispute arises and Caitlin withdraws, causing a dissolution of the partnership. Caitlin had the power to dissolve the partnership, but not the legal right; therefore, she could be held liable for damages by Erin.

c. **By operation of law** (done without agreement of the partners)

(1) The business becomes illegal. This automatically terminates the partnership.

(2) Bankruptcy of the partnership or an individual partner. This must be by adjudication and not merely insolvency.

(3) Death of one or more of the partners (This provision can be overridden by agreement of the partners.)

(4) Court decree. A court decree can be obtained based on the following:

(a) If just and equitable to terminate the partnership

(b) Serious misconduct of a partner—such as habitual drunkenness

(c) Incapacity of a partner; cannot perform duties—such as insanity

(d) Business is impractical

(e) Other partner habitually or purposely commits breach of the partnership contract

4251.09 Priority of payments on dissolution

- **a.** Creditors of the partnership are paid first.
- **b.** Loans made to partnership by partners are next repaid to the extent capital remains.
- **c.** Return of capital contributions made by the partners is next in line of priority.
- **d.** Profits or losses are then divided among the partners as follows:
  - (1) As agreed upon in the partnership agreement
  - (2) Equally if there is no partnership agreement to the contrary
  - (3) Losses are divided the same as profits if there is no partnership agreement to the contrary.

4251.10 Marshaling of assets

- **a.** Partnership creditors get first rights on the partnership assets, and individual creditors get first rights on individual partners' assets.
- **b.** Partnership creditors must be completely paid before creditors of individual partners have any rights in partnership assets.
- **c.** Creditors of individual partners must be completely paid before partnership creditors have any rights in the personal assets of the individual partner.

Corporations

4251.11 Entity

- **a.** A corporation is an organization formed under state law or federal law that is legally separate and distinct from those persons who own the corporation. This means the shareholders are not liable for corporate obligations except to the extent of their investment in the corporation.
- **b.** Due to its separate legal existence, the corporation is also generally not liable for the personal obligations of its shareholders, directors, officers, or employees.
- **c.** The corporate entity is recognized as being separate except when it is used to defeat public convenience, perpetrate fraud, evade the law, or commit a crime.
- **d.** Ignoring the corporate entity is referred to as "piercing the corporate veil." When this is done, the shareholders can be held liable by the creditors of the corporation for corporate obligations.
- **e.** For courts to ignore the corporate entity and *"pierce the corporate veil,"* two elements must generally be present:
  - (1) **Domination by a shareholder or group of shareholders.** The idea here is that the shareholder or shareholders control the corporation for their own benefit in an attempt to insulate themselves from liability for wrongdoing.
  - (2) **Improper use of the corporation.** Various types of improper use by the dominating shareholder can cause the corporation to be disregarded as a separate entity. For example:
    - (a) Using the corporation to perpetrate a fraud

(b) Thin capitalization of the corporation; here the corporation is formed as a "dummy" entity with insufficient capital to meet reasonably expected business obligations.

(c) Shareholders looting the corporation to the detriment of the corporation's creditors, such as having the corporation sell assets to a shareholder for a price far below fair market value

f. The corporation can hold property in the corporation's name.

g. The corporation can sue and be sued in the corporation's name.

h. Contracts can be entered in the corporation's name with the corporation as a party to the contract.

4251.12 State incorporation laws

a. When states first allowed corporations to be formed, it was necessary for the incorporators to appear before the state legislature to ask it to be allowed to form the corporation.

b. If the legislature decided to allow the formation of the corporation, it granted a corporate charter. Legally, this was permission to operate as a corporation in the state.

c. The individual appearances of the incorporators before the legislature became very time-consuming, so the legislatures drafted a general incorporation law and delegated the administrative responsibility to a state official. Most states designate the secretary of state.

d. Model Business Corporation Act (MBCA)

(1) The act is the model that most states use as the basis for their incorporation laws.

(2) The MBCA was first drafted in 1946 and has been amended many times. It was completely revised in 1984 and has been amended since then.

(3) The majority of states have adopted the revised MBCA, in whole or in part.

(4) The revised MBCA is used on the CPA Examination to cover the topic of corporation law.

(5) Individual state corporation law may differ somewhat from the revised MBCA. Questions on the CPA Examination, however, should be answered using the rules of the revised MBCA.

e. Foreign corporations

(1) All of the states allow foreign corporations to do business in the state.

(2) Foreign corporations doing business in intrastate commerce must qualify to do business in the state and obtain a certificate of authority from the state. Failure to obtain a certificate results in the denial of access to the courts by the corporation as a plaintiff, a statutory penalty, and personal liability of the officers and directors.

(3) A foreign corporation engaged wholly in interstate commerce need not qualify or obtain a certificate of authority.

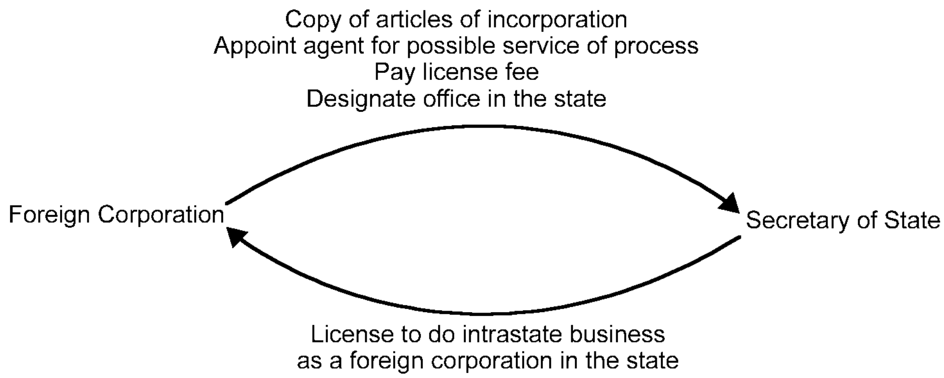
(4) Only the state of incorporation can regulate the internal affairs of a corporation.

(5) Foreign corporations are treated the same as domestic corporations for regulation purposes. If a state treated foreign and domestic corporations differently, it would

be a burden on interstate commerce and, therefore, a violation of the Commerce Clause (unconstitutional).

(6) A foreign corporation, registered or unregistered, can always defend itself as a defendant. A state cannot take away this right, because it would be a denial of due process.

(7) The following is a diagram of a foreign corporation applying to do business in the state:



4251.13 Formation of a corporation

a. A corporation is formed by applying to the state.

b. **Start of corporate existence.** Issuance of a certificate of incorporation by the secretary of state is considered the start of corporate existence. Such certificate puts third parties on notice that a corporation exists with limitations on liability for the shareholders.

c. **Domicile.** A corporation may have only one domicile—its state of incorporation. However, it can qualify to do business in any other state.

(See section **4511** for additional information on corporation formation.)

4251.14 Incorporators

a. Incorporators are the individuals who apply to the state for incorporation.

b. Incorporators need not have any interest in the corporation. Sometimes the secretaries in the lawyer’s office are made the incorporators.

c. Incorporators owe a fiduciary duty to the corporation being formed.

4251.15 Promoters

a. Promoters are the motivating force in creating the corporation. They do such things as employing services of attorneys and accountants, borrowing funds, and purchasing property for use by the nascent (to be formed) corporation.

b. Promoters owe a fiduciary duty to the corporation being formed.

c. Promoters are liable on preincorporation contracts to third parties unless the following are true:

(1) The corporation adopts the contract.

(2) The contract expressly says the promoter is not liable on the contract.

(3) The contract indicates that neither party is obligated unless the corporation is formed.

d. Promoters are liable on preincorporation contracts if they contract in their own name or in the name of the not-yet-formed corporation, and the corporation is not formed or does not adopt the contract.

e. Promoters cannot make secret profits in forming the corporation.

4251.16 Corporation citizenship

a. Citizenship must be determined to see if a federal court has jurisdiction of a case involving the corporation based on diversity of citizenship.

b. The federal courts have jurisdiction only if the parties (plaintiff and defendant) are citizens of different states and the amount in controversy exceeds $75,000.

c. For this purpose, a corporation is a citizen of both the state of incorporation and the state where its principal place of business is located.

4251.17 Articles of incorporation

a. The articles of incorporation are like a constitution—they outline the organization of the corporation.

b. Corporate existence starts when the articles of incorporation are filed or when the certificate of incorporation is issued. There is a split of authority. It depends on which view the state selects.

c. The articles are prepared by the promoters or incorporators.

d. The articles of incorporation *must* include the following:

(1) Name of the corporation

(2) Number of shares the corporation is authorized to issue

(3) Street and mailing address of the initial registered office and the name of its initial registered agent at that office

(4) Name and address of each incorporator

e. The articles of incorporation *may* include the following:

(1) Period of time for the corporation's existence—usually is perpetual

(2) Purpose—usually stated as any legal purpose

(3) Share structure, including whether or not there is a preemptive right

(4) Structure of the board of directors and names and addresses of persons serving as directors until the first annual meeting

f. Amending the articles of incorporation:

(1) All corporations allow for changing, deleting, or adding to their articles of incorporation.

(2) To amend the articles of incorporation, the following must be done:

(a) The board of directors adopts a resolution and submits it to the vote of the shareholders.

(b) Shareholders must be given written notice.

(c) A majority of shares entitled to vote is generally necessary for approval.

(d) The amendments must be filed with the secretary of state.

4251.18 Bylaws

a. **Bylaws:** Rules adopted by the corporation's board of directors for regulation and management of the affairs of the corporation

(1) Bylaws are subordinate to the articles of incorporation and the state of incorporation's corporation laws.

(2) Bylaws may not conflict with the articles of incorporation or with the state's corporation laws.

b. Initial bylaws are adopted by the board of directors.

c. Bylaws can be changed by the board of directors unless reserved to the shareholders in the articles of incorporation.

4251.19 Suing a corporation

a. Due process requires that anyone being sued, even a corporation, must be given notice.

b. When a corporation incorporates (for a domestic corporation) or applies to do business in another state (for a foreign corporation), it must designate a registered agent to receive service of process if the corporation is sued.

c. The secretary of state maintains a listing of the registered agents for all corporations in the state.

4251.20 Permitted actions of a corporation

a. **Owning own shares.** A corporation may buy and sell its own shares if cash and retained earnings permit. If insolvent or if the purchase would cause insolvency, the corporation cannot acquire the shares. Shares repurchased by the corporation are called treasury shares.

b. **Indemnification of officers, directors, employees, and agents**

(1) A corporation may indemnify an officer, director, employee, or agent of the corporation for any legal action (civil or criminal) done in good faith for the corporation. Generally, indemnification cannot be made if there was negligence or misconduct on the part of the officer, director, employee, or agent.

(2) Indemnification is often done through insurance.

c. **Loans to officers and directors**

(1) A corporation may make loans to officers and directors. Generally, either the shareholders must approve the loan, or the directors must approve it after finding that approval of the loan will benefit the corporation.

(2) For *corporate* law purposes, the loans can even be without interest.

d. **Employment incentives.** A corporation may offer incentives to officers and key employees. These incentives may include the following:

(1) Stock purchase option

(2) Bonus

(3) Liberal expense account

(4) Country club membership

4251.21 Prohibited actions of a corporation

The state incorporation law and the corporation's articles of incorporation and bylaws often contain items that cannot be done. These items may include the following:

a. Paying a dividend that would impair stated capital

b. Taking advantage of a minority shareholder

4251.22 Major changes in corporate structure

a. Some major changes in a corporation are permitted only if approved by a majority vote of the shareholders. These changes include the following:

(1) **Merger.** One or more corporations are acquired by another existing corporation, thereby losing their separate corporate existence.

(2) **Consolidation.** Two or more corporations join together as a new corporation, thereby losing their separate corporate existence.

(3) **Sale** of substantially all the assets of a corporation not in the ordinary course of business.

b. Merger or consolidation

(1) Two or more corporations can merge or consolidate. To do so, the following must occur:

(a) The board of directors approves a plan and submits it for shareholder approval.

(b) Written notice of an annual or special meeting must be given to shareholders at least 20 days prior to the meeting.

(c) A majority of shares entitled to vote is necessary for approval.

(d) Articles of merger must be filed with the secretary of state. If the state of incorporation of the surviving corporation and the state of the merged corporation are different states, the articles of merger must be filed in both states.

(2) Creditors of the existing corporation are still creditors of the new or surviving corporation.

c. Merger of subsidiary corporation. If a corporation owns at least 90% of a subsidiary corporation, it may merge without vote of the shareholders of either corporation.

d. Sale of substantially all the assets of a corporation

(1) A sale of assets in the usual course of business can be done by the board of directors alone, without shareholder approval.

(2) A sale of assets not in the usual course of business must be done by resolution of the board of directors, notice to shareholders, and approval by a majority of shareholders.

4251.23 Termination of the corporation

a. Articles of dissolution are filed with the secretary of state after a corporation has been dissolved.

b. Dissolution of a corporation requires the corporation to wind up its business affairs and liquidate its assets.

c. If the corporation has not yet done business or issued shares, it can be dissolved by majority vote of the incorporators or initial directors.

d. A corporation that is doing business can be dissolved by a resolution of the directors approved by shareholder vote.

e. The secretary of state has the power to force a corporation to dissolve involuntarily through administrative or judicial proceedings for such conduct as the following:

(1) Failing to file annual reports

(2) Failing to pay taxes

(3) Failing to appoint a registered agent in the state

(4) Obtaining the articles of incorporation by fraud

f. A shareholder may obtain judicial dissolution of a corporation if any of the following occur:

(1) The directors are deadlocked, and irreparable injury to the corporation is threatened.

(2) The directors or those in control of the corporation are acting in a manner which is illegal, oppressive, or fraudulent.

(3) Shareholders are deadlocked and cannot elect directors for two years.

(4) Corporate assets are being misapplied or wasted.

g. Creditors may obtain a judicial dissolution if the corporation is insolvent.

h. Termination of the corporation occurs when the assets are liquidated and the proceeds distributed to creditors and shareholders.

4252 Rights, Duties, Legal Obligations, and Authority of Owners and Management

Partnerships

4252.01 Who can and cannot be a partner

a. **Minor.** May become a partner but can disaffirm the partnership contract. Partnership creditors have a preference on partnership assets before a minor gets his/her capital contribution returned. Partnership creditors may not get personal assets of a minor partner if the minor partner disaffirms.

b. **Insane person.** A judicially declared insane person cannot make a contract—any effort is void. If a person becomes insane after making a contract, the other partner may get dissolution due to the insanity by way of a court order.

c. **Corporation.** The Uniform Partnership Act (UPA) allows a corporation to become a partner, but the general corporation laws of some of the states do not allow a corporation to become a partner.

4252.02 Authority of a partner

a. Authority of a partner is merely an extension of agency law.

b. Agency law applies to partnerships in the following manner:

(1) Each partner is an agent for the partnership. The partnership is the principal.

(2) A partnership is liable for the actions of a partner if the partner either:

(a) has actual authority or

(b) is acting within the apparent scope of the partnership activity and the third party does not know the actual authority of the party.

(3) If the partnership is not liable on a contract, then the individual partner making the contract is liable.

(4) A partner is personally liable for the torts the partner commits.

(5) A partnership is liable for the torts of a partner if the partner was acting within the scope of the partnership business when the tort occurred.

(6) A partner is personally responsible for his/her crimes.

(7) A partnership is not liable for a partner's crimes unless the other partners actually participated in the crimes.

(8) If a partner enters a contract without authority, the partnership may recover damages from the wrongdoing partner if the partnership is held liable to a third party.

4252.03 Types of authority

a. Actual

(1) Also called *real authority*

(2) May be expressed or implied authority

b. Apparent

(1) Sometimes called *ostensible* or *customary authority*

(2) When a partnership restricts a partner's actual authority, the partner may still have apparent authority to act. This occurs because a third party can reasonably believe that the partner, who is an agent for the partnership, can perform acts necessary to carry out the partnership business.

Example: Erin, Brian, Kevin, and Caitlin are partners and agree that only Kevin can enter contracts to purchase inventory for the partnership. If third parties are not notified of this restriction, Erin, Brian, and Caitlin will have apparent authority to purchase inventory.

(3) Different types of firms have different authority.

(a) **Trading partnership:** Much customary authority

(b) **Nontrading partnership:** Little customary authority (A nontrading partnership does not normally engage in activities such as borrowing money. There is, therefore, no apparent or customary authority to borrow money. A trading partnership would regularly do this, for example, to finance inventory.)

(4) Typical customary or apparent authority examples include the following:

(a) Entering into usual contracts for that type of business

(b) Sales in the ordinary course of business

(c) Purchasing goods in the scope of business

(d) Loans for a trading partnership

(e) Insuring property of the partnership

(f) Employing persons for the partnership

c. Certain actions are completely unauthorized, and no partner can bind the partnership by these acts. They require the unanimous consent of all partners. Examples include the following:

(1) A decision to go out of business

(2) Suretyship (guaranty)—cannot promise to pay somebody else's debts or obligations

(3) A decision to arbitrate a dispute between the partnership and a third party

(4) Confess judgment—this is equivalent to pleading guilty in advance

(5) Assignment for the benefit of creditors

(6) Make a personal obligation for the partnership to pay

4252.04 Partner's individual liability

a. Every partner is the agent of the partnership for the purpose of its business. The partnership is bound by all transactions negotiated by a partner if such transactions are within the usual course of partnership business.

b. **Tort.** If the wrongful act is committed within the scope of and in the course of partnership business, the partners and the partnership will be jointly and severally liable. *Jointly and severally liable* is used in civil cases where two or more people are liable for damages (such as a partnership). The winning plaintiff can collect the entire judgment from any one of the parties, or all the parties, in various amounts, until the judgment has been paid in full. If any one of the defendants does not have sufficient money or assets to pay their portion, the other defendants must make up the difference.

c. **Crimes.** Only the partner who commits a crime is liable unless the other partners participate.

d. **Contracts.** Partners are jointly (all together at the same time) liable for contracts made by a partner within the scope of the real or apparent authority of a partnership. If the contract is made in the partner's personal name, the other partners are liable as undisclosed principals.

4252.05 Withdrawal of a partner

a. Existing creditors are entitled to actual notice of a partner withdrawing. If there is no notice, the withdrawing partner could still be liable to a creditor of the partnership for partnership debts that happened after the withdrawal.

b. Creditors who have not dealt with the partnership previously are entitled only to constructive notice (i.e., in a newspaper).

4252.06 Admission of a new partner

a. New partners are liable for all partnership obligations that arise after they are admitted.

b. New partners are liable for all partnership obligations that arose before admission, but only to the extent of their share of the partnerships' assets. The new partner's individual assets are not available to satisfy these claims.

4252.07 Rights of partners

a. **Right to share in profits.** Partners share equally in profit regardless of the amount of capital contributions or the amount of time spent in the partnership business. The partnership agreement may specify that profits are shared differently. (This is why a written agreement is important.)

b. **Right to return of capital.** When a partnership is being dissolved, each partner has the right to obtain the return of his/her capital contribution before the partnership profit or loss is calculated. This occurs after partnership creditors are paid.

c. **Right to participate in management.** There is equal right to participation in management among partners unless they agree otherwise. This is true regardless of the amount of capital contributed or the amount of services rendered to the partnership.

d. **Right to information and inspection of the books.** Any partner has the right to demand to see the books and accounts of record at any point in time.

e. **Right to an accounting.** This is the right of a partner to come into court to force other partners to give an accounting of the partnership activities.

f. **Rights in specific partnership property.** Individual partners do not own any part of any specific partnership property. Unless agreed otherwise, the Uniform Partnership Act (UPA) states that each partner has an equal right to possess partnership property for partnership purposes. The right to possess and control partnership property cannot be transferred to a third party.

g. **Right to compensation.** Unless agreed otherwise, a partner is not entitled to any salary for services provided to the partnership. After a partnership is dissolved, however, a partner who is in charge of winding up the affairs of the partnership is entitled to reasonable compensation for those services.

h. **Right to reimbursement.** A partner that incurs reasonable expenses in carrying out partnership business has a right to reimbursement from the partnership.

Example: Dave, a partner, attempts to deliver goods to Brian on behalf of the partnership. Brian breaches the contract by refusing to accept the goods. Dave pays storage expenses for the goods and incurs costs to ship them to another buyer. If Dave pays these expenses, he can generally get reimbursed by the partnership.

4252.08 Duties of partners

a. **Fiduciary.** This means trust and confidence, loyalty and good faith to the firm, obedience to the partnership agreement, exercise of reasonable care in doing partnership business, providing needed information to the partnership, and providing an accounting of partnership matters.

b. **Duty to share in losses.** Division of losses is in the same percentage as sharing of the profits unless agreed otherwise in the partnership agreement.

4252.09 Assignment or transfer of partnership interest

a. A partner may assign or transfer all or part of his/her interest in the partnership to someone else.

(1) This does not dissolve the partnership. The assignor is still a partner.

(2) Consent of the other partners is not required for a valid assignment or transfer.

(3) The assignee does not automatically become a partner nor does the assignee have any of the rights of a partner. If the other partners agree, the assignee could become a partner.

(4) The assignee obtains only the right to the assignor's share of partnership profits and what the assignor would receive if the partnership is dissolved.

b. As long as the assigning partner performs their required duties, the other partners are not adversely affected by the assignment.

Corporations

4252.10 Board of directors

a. The board of directors exercises corporate powers and manages the business. They are in a fiduciary relationship with the corporation.

b. Directors need not be residents of the state of incorporation.

c. Directors need not be shareholders.

d. They have authority to fix their own compensation unless the articles of incorporation or bylaws say they are prohibited from doing so.

e. The board can be one or more persons as fixed by the articles of incorporation or bylaws. Traditionally, state statutes required at least three directors. Today most statutes permit fewer than three directors for corporations that have fewer than three shareholders.

f. The board holds office until the next annual meeting or until replaced.

g. The board can be divided into classes, with staggered election dates, if there are nine or more directors.

h. The board can fill vacancies for the unexpired time by a majority vote of the remaining directors.

i. Directors can be removed by the shareholders' vote with or without cause. Directors serve at the pleasure of the shareholders.

j. The board has a quorum when a majority of the number of directors is present.

k. The board can make an act effective if it is passed by the majority of the directors present at a meeting when a quorum exists.

l. The board of directors can divide itself into committees and delegate power to them. Examples are the executive committee and the audit committee.

m. The board can meet anywhere. It need not be in the state of incorporation.

4252.11 Notification to directors of regular or special meetings of the board of directors is specified by the bylaws.

4252.12 Meetings of the board of directors can be conducted via a conference call. They merely have to be able to hear each other at the same time.

4252.13 The board of directors may act without a meeting if all directors consent in writing.

4252.14 **Loans to directors.** Loans to directors are allowed only if authorized by the shareholders.

4252.15 **Liability of directors.** A director is individually liable if the director engages in illegal conduct or conduct that is a breach of fiduciary duty to the corporation. For example, if the director votes:

- **a.** for an illegal dividend, such as a dividend that would make the corporation insolvent,
- **b.** to illegally buy shares of the corporation, or
- **c.** to pay off shareholders before creditors,

…then the director would be individually liable.

4252.16 **Business judgment rule.** This rule protects the directors from shareholder lawsuits alleging a lack of due care on the part of the directors in carrying out the corporation's business. This rule will apply as follows:

- **a.** When the board makes an informed decision
- **b.** When there is no conflict of interest
- **c.** When there is a rational basis for the board's decision

4252.17 **Dividends**

- **a.** Dividends are declared by the board of directors.
- **b.** They may be paid in cash, property, or shares of the corporation.
- **c.** They cannot be declared if the dividend would make the corporation insolvent.
- **d.** Cash and property dividends are paid out of unreserved and unrestricted earned surplus (retained earnings). Some states allow payment out of net earnings of the current year and the previous year taken together, even if there is a negative earned surplus.

4252.18 **Officers of the corporation**

- **a.** The *officers* are appointed by the board of directors.
- **b.** They are the president, vice president(s), secretary, and treasurer.
- **c.** One person can hold multiple offices, but the president and secretary generally cannot be the same person. Exceptions to this rule exist in some states where "one person corporations" are allowed.
- **d.** The officers can be removed by the board of directors for any reason, but firing an officer may be a breach of an employment contract for which the corporation may be liable.
- **e.** Officers of a corporation owe a fiduciary duty to the corporation.

4252.19 **Managers of the corporation**

- **a.** The *managers* are hired by the officers.
- **b.** The managers serve at the pleasure of the *officers,* unless they have negotiated an employment contract.
- **c.** The managers owe a fiduciary duty to the corporation.

4252.20 Shareholders

- **a.** Shareholders are the owners of the corporation.
- **b.** Shareholders do not generally owe fiduciary duties to the corporation. Controlling shareholders may be deemed to owe fiduciary duties that prevent them from exercising control to further their own interests to the detriment of the corporation and minority shareholders.
- **c.** Shareholders elect the board of directors.

4252.21 Shareholder voting

- **a.** A *quorum* for a meeting is a majority of shares outstanding, unless the articles of incorporation specify otherwise.
- **b.** A majority of the quorum prevails on votes, unless articles of incorporation specify otherwise.
- **c.** Treasury shares get no votes. Treasury shares are those owned by the corporation.
- **d.** A vote can be in person or by proxy. A proxy is a signed document authorizing another person to vote the shareholders' shares of stock. Proxy must be written and is valid for a maximum of 11 months.
- **e.** **Cumulative voting**
  - (1) Cumulative voting applies only for electing the board of directors.
  - (2) The number of votes a shareholder gets is determined as follows: Number of shares owned × Number of directors being elected.
  - (3) A shareholder can distribute votes in any way desired. All the votes can be put on one nominee.
  - (4) Cumulative voting increases the chance of minority representation on the board of directors.
  - (5) Most states permit cumulative voting if the articles provide for it.
- **f.** **Straight voting:** One vote for each share for each directorship to be filled

4252.22 Voting by proxy

- **a.** A shareholder may vote by proxy.
- **b.** A director is not permitted to vote by proxy.

4252.23 Shareholder meetings

- **a.** Annual meeting details are fixed by the bylaws.
- **b.** Shareholders are entitled to notice of place, day, and hour of meetings 10 to 50 days before the meeting.
- **c.** The purpose must also be given for holding special (not annual) shareholder meetings. The meeting is then limited to these stated purposes.
- **d.** **Notice:** Mailing details by U.S. mail to shareholders of record

4252.24 Preemptive right

a. Preemptive right is the right of a shareholder to buy a pro rata share of newly issued stock.

b. The purpose is to allow the current shareholders to maintain their proportionate interest in the corporation.

c. In most states, a shareholder has no preemptive right unless the right is given in the articles of incorporation.

d. In some states, a shareholder has a preemptive right unless it is denied in the articles of incorporation.

4252.25 Dissenting shareholders

a. Dissenter's rights exist for shareholders who disagree with certain corporate actions. Shareholders can dissent from the following actions:

(1) Merger

(2) Consolidation

(3) Sale of substantially all the assets of the corporation, not in the usual course of business

b. To dissent, the shareholder must file a written objection with the corporation, vote against the proposal, and make written demand for payment of the fair value of the shareholders' stock within 10 days of the vote.

c. Fair value is the stock value on the day before the proposal was voted on by the shareholders.

4252.26 Shareholders' lawsuits

a. If a group of shareholders has been injured, a shareholder may be able to file a *class action suit* on behalf of the class.

b. Most of these suits arise from violations of federal securities laws and have the following requirements:

(1) The number in the class is so large it is impractical for all to sue.

(2) The shareholder suing has substantially the same interest as others in the class.

(3) The shareholder can fairly and adequately protect and present the interests of the class.

c. A shareholder may also be able to file a *derivative suit* on behalf of the corporation when the corporation has been injured.

d. Most of these suits are brought against directors, officers, or someone closely related to them. These suits require that the shareholder is either of the following:

(1) Currently a shareholder at the time the derivative suit is filed

(2) Was a shareholder when the wrongful act was committed against the corporation

e. Generally, a derivative suit can be brought only after the shareholder demands that the board of directors file suit. This demand requirement is excused if it would be futile (e.g., all of the directors have committed fraud against the corporation).

4252.27 Inspection of records

a. At common law, shareholders have certain rights to inspect the books and records of the corporation. Generally, the shareholder right to inspect is found in state corporation statutes.

b. The Model Business Corporation Act (MBCA) requires that a shareholder must have a proper purpose for an inspection. Also, the right of inspection may be limited to shareholders who own at least 5% of the corporation's stock *or* have owned their stock for at least six months.

c. The Revised Model Business Corporation Act (RMBCA) gives all shareholders an absolute right to inspect the following:

(1) Shareholder lists

(2) Articles of incorporation

(3) Bylaws

(4) Minutes of shareholder meetings held during the past three years

d. The RMBCA requires that the shareholder have a proper purpose for inspection of other records such as accounting and tax records, minutes of board of directors' meetings, and minutes of shareholder meetings held more than three years in the past.

e. Officers or agents of the corporation who improperly deny a shareholder's inspection request can be held liable for damages. Under the RMBCA, the shareholder can recover an amount that equals up to 10% of the value of the shares owned in the corporation.

f. The shareholder can appoint an agent, such as an attorney or accountant, to inspect the books and records of the corporation on their behalf.

Section 4300
Federal Taxation of Property Transactions
(5%–15%)

4310 Basis of Assets

Overview

4310.01 **Two major types of property:** All property falls into one of two categories: real property or personal property.

1. **Real property (realty):** Land and anything permanently attached to the land or very closely and exclusively associated with the use of the land; immovables

   Examples: Land, buildings, and growing trees

2. **Personal property (personalty):** Property that is not real; movables

   Examples: Car, table, or book

4310.02 **Conversion from real to personal property:** Conversion from real to personal property is called *severance.*

Examples of severance:

- **a.** A growing tree is cut into firewood. While growing in the ground, the tree is real property. When cut into firewood, it becomes personal property.
- **b.** Sand is dug from the ground and put on a truck. While in the ground, the sand is real property. When dug from the ground and put on the truck, it is personal property.

4310.03 **Conversion from personal to real property:** Conversion from personal to real property is called *attachment.*

Examples of attachment:

- **a.** A brick is mortared into the wall of a building. While loose, the brick is personal property; when mortared into the wall, it becomes a part of the real property.
- **b.** A central air conditioning unit is installed in a house during construction. The unit is personal property until it is installed, then it becomes real property (assume the unit is affixed to the structure).

4310.04 For federal tax purposes, all property is either classified as ordinary income property or as a capital asset.

Tax Treatment of Gains and Losses

4310.05 When a taxpayer has determined that the taxpayer has a gain or a loss to be recognized, the next step is to establish whether it is to be treated as a capital gain or loss or as an ordinary income or loss item.

4310.06 A capital gain or loss is that gain or loss arising from the sale or exchange of a capital asset.

4310.07 **Capital assets** are defined as all property, *except* for the following:

- **a.** Property held for resale (inventory)
- **b.** Depreciable property or real property used in a trade or business
- **c.** Accounts or notes receivable acquired in normal business operations

d. A copyright or a literary, artistic, or musical composition in the hands of the creator or anyone who assumes the creator's basis (property received through gift)

e. U.S. government publications received from the government other than by purchase at the price that it is offered for sale to the public

f. Certain commodities derivative instruments held by a commodities derivatives dealer

g. Any hedging transaction that is clearly identified as such before the close of the day on which it is acquired, originated, or entered into

h. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer

4310.08 **Real property subdivided for sale:**

a. Individuals and S corporations subdividing real estate for sale may qualify for capital gain treatment if the following conditions apply:

(1) Subdivider must *not* be a real estate dealer.

(2) No substantial improvements may be made to the lots sold.

(3) Lots sold must be held at least five years (unless inherited).

b. All gain is capital gain until the year the sixth lot is sold. Contiguous lots sold to one buyer are treated as one lot.

(1) When the sixth lot is sold, 5% of the revenue from all lots sold that year is ordinary income.

(2) This ordinary income is offset by any selling expenses to determine the net amount taxed as ordinary income. Any gain not taxed as ordinary income is capital gain.

Basis of Assets

4310.09 In determining the taxpayer's investment (adjusted basis) in an asset, several cost factors must be considered.

	Original basis
+	Capital additions
–	Capital recoveries
=	Adjusted basis

a. The basis of property *must be adjusted* by the cost of any improvements made since its acquisition. Real property taxes and mortgage interest on unimproved and unproductive real property may be capitalized at the election of the taxpayer.

b. The basis of property *must be reduced* for depreciation and depletion along with other recoveries such as casualty losses.

c. The adjusted basis is the tax equivalent of the financial accounting "net book value."

4310.10 Establishing the basis of property acquisitions depends primarily on the method by which the property was acquired.

a. **Standard purchase**—Basis is cost plus all the ancillary expenses incurred to make the asset functional (i.e., installation costs). The basis includes all costs to get the asset ready for its intended use.

b. **Group purchase**—The cost is allocated to the individual assets in proportion to their fair market values. This situation occurs when one price is paid for multiple assets where the total purchase price does not equal the fair market value of all of the assets combined. In this case, the assets must be given a basis based on their relative fair market values. The entire purchase price is allocated to the various assets purchased based on their relative fair market values.

Example: Land and a building with fair market values (FMVs) of $100,000 and $50,000 are purchased for $125,000 for both assets. The $125,000 total purchase price would be allocated to the two assets based on their relative FMVs. The total FMV of the two assets is $100,000 + $50,000 = $150,000. For the land, the basis allocated is ($100,000 Land FMV ÷ Total FMV $150,000) × $125,000 purchase price = $83,333. For the building, the basis allocated is ($50,000 Building FMV ÷ Total FMV $150,000) × $125,000 purchase price = $41,667.

c. **Bargain purchase**—Basis is the cost plus the bargain element (fair market value at the date of the bargain purchase).

d. **Inherited property**—Basis is usually the fair market value at date of death.

(1) Fair market value (FMV) six months after death, of all property included in the estate, is an alternative for an estate tax return if this produces a lower value for the gross estate and a lower estate tax liability. The FMV at six months after death can only be used for basis if an estate tax return is filed using that FMV. This only occurs for taxable estates (i.e., estates large enough to be taxed), as a requirement for using the alternate valuation date is that it results in a lower estate tax liability.

(2) If the alternative value is chosen and property is disposed of before the six-month period has expired, that property shall be valued at the fair market value at the date of disposition, the sale price.

(3) This is often called a *stepped-up basis.* The inherited property's basis is "stepped up" to fair market value when the property is received as part of an estate after the death of the original property holder.

e. **Gift property acquired since January 1, 1921:**

(1) **Basis to compute gain**—donor's basis

(a) On gifts made before 1977, any gift taxes paid by the donor could be added to the donor's basis as long as the addition of the taxes did not cause the basis of the property in the donee's hands to exceed the fair market value of the property at the date of the gift.

(b) On gifts made after 1976, the basis of the property is increased by the gift tax attributable to the net appreciation in the value of the gift property, but the donee's basis cannot be increased beyond the fair market value of the property at the date of the gift.

(2) **Basis to compute loss**—lower of:

(a) donor's basis plus the gift tax adjustment or

(b) fair market value at date of gift

In certain situations, neither a gain nor a loss can be computed on the sale of property received by gift. In such a situation, the selling price is less than the basis for gain and more than the basis for loss.

(3) **Basis for calculating depreciation**—Use the gain basis.

(4) **Basis of gifts made prior to 1921**—fair market value at date of gift

Example: An individual (the giftee) receives a gift of a piece of property from an aunt (the giftor) with a basis to the aunt of $10,000 and a fair market value on the date of the gift of $8,000. No gift taxes were due or paid on this gift. The individual receiving this piece of property must keep track of two bases: the carryover basis ($10,000) and the fair market value on the date of the gift ($8,000). The basis that is used by the individual holding the property now depends on the price when the property is ultimately sold.

(1) **Property sold for $12,000:** If the property is ultimately sold for $12,000, then the basis used by the giftee is the higher carryover basis of $10,000. Thus, the gain realized and recognized by the giftee is $2,000 ($12,000 amount realized less $10,000 basis).

(2) **Property sold for $7,000:** If the property is ultimately sold for $7,000, then the basis used by the giftee is the lower fair market value on the date of the gift of $8,000. Thus, the loss realized and recognized by the giftee is $1,000 ($7,000 amount realized less $8,000 basis).

(3) **Property sold for $9,000:** If the property is ultimately sold for $9,000, then the basis used by the giftee is also $9,000. This is the situation where the property at the time of gift is loss property (i.e., the fair market value is less than the adjusted basis) and the property is ultimately sold for an amount in between the higher adjusted basis to the giftor and the lower fair market value at the time of the gift. This $9,000 basis is used so that no gain or loss is realized or recognized.

f. **Personal property converted to income production:**

(1) **Basis for gain**—adjusted basis of the asset at conversion minus allowable depreciation after conversion

(2) **Basis for loss**—lower of:

(a) the adjusted basis of the asset at conversion minus allowable depreciation or

(b) fair market value at conversion minus allowable depreciation thereafter

(3) **Basis for calculating depreciation**—lower of:

(a) the adjusted basis of the asset at conversion or

(b) fair market value at conversion

g. **Property received as compensation for services:** Basis is the fair market value of the property when received.

h. **Property transferred to a controlled corporation in exchange for its stock:**

(1) The basis of stock received for property transferred to a controlled corporation is equal to the basis of the property exchanged plus any recognized gain on the exchange minus any cash and/or other property received.

(2) The basis of property acquired by the corporation is the same as it was in the possession of the transferor plus any gain recognized by the transferor on the exchange.

(3) To qualify as a controlled corporation, persons transferring property to a corporation for its stock or securities must own 80% of the voting stock plus 80% of all other stock of the corporation immediately after the exchange.

(4) These rules for transfers to a controlled corporation are under IRC Section 351 and apply to both S corporations and C corporations.

i. **Taxable exchange**—Basis is the fair market value of the property received.

j. **Wash sale:**

(1) A wash sale takes place when securities are sold at a loss and replaced with substantially identical securities within 30 days *before* or *after* the sale.

(2) Such losses are not recognized—they are deferred. The deferred loss increases the basis of the stock or securities acquired.

(3) This law does not apply to dealers.

(4) This is a 61-day period around the date of sale—30 days prior to sale, day of sale, and 30 days after the sale—during which any purchases during this time may disallow losses to be taken under the wash sale rules.

(5) The deferred losses get taken into account through the increased adjusted basis of the newly purchased stock.

(6) The IRS has ruled that the wash sale rules specifically do not apply to any virtual currencies.

Example: The taxpayer sells 100 shares of stock in Company XYZ for $10 per share. His basis in these shares was $15 per share (or $1,500 total basis in all 100 shares: 100 shares × $15 per share basis). Twenty days after he sells the shares, he decides to repurchase 100 shares of stock in Company XYZ, also for $10 per share. He has a realized loss in his originally sold shares of $5 per share ($10 amount realized per share less $15 basis per share), with a total realized loss of $500 (100 shares × $5 per share realized loss). However, he recognizes $0 in loss as this $500 loss is deferred under the wash sale rules as he sold the securities and, within 30 days prior- or post-sale, he repurchased. This deferred loss gets taken into account with the newly purchased stock's adjusted basis. The adjusted basis in the newly purchased shares of XYZ stock is $15 per share ($10 per share purchase price + $5 per share deferred loss), with a total basis in the 100 shares of $1,500. This treatment ensures that the deferred loss gets recognized when the shares are sold outside the window of repurchase that is banned under wash sale rules.

4310.11 Intangible assets

a. IRC Section 197 intangibles are a qualifying asset acquired and held in connection with the conduct of a trade or business. This includes goodwill, going-concern value, trademarks, and franchises.

b. Copyrights, patents, and covenants not to compete are included as an amortizable intangible asset when acquired with the purchase of a business.

c. Interests in land, financial interests, computer software, mortgage servicing, and leases of tangible personal property are excluded from the definition of Section 197 intangibles.

d. Research and experimental expenditures may be (1) expensed in the year paid or incurred, (2) capitalized and amortized over a period of time not less than 60 months, or (3) capitalized and amortized ratably over 10 years and thereby avoiding alternative minimum tax considerations.

4310.12 Organization expenses and start-up costs

a. An election may be made to amortize **organizational expenses** over a period of 15 years (180 months) or more. A special rule allows an immediate expensing of the first $5,000 of these costs. However, this immediate expensing is phased out dollar-for-dollar if total organizational expenses exceed $50,000. Thus, if total organizational expenses are $55,000 or greater, none of the organizational expenses can be immediately expensed.

(1) This election will be deemed made if the taxpayer deducts and amortizes the organizational expenses on the corporation's first tax return.

(2) Corporations not making this election receive no deduction for organization costs until the company is liquidated.

(3) Any organizational or start-up expenditures not immediately expensed are capitalized and then amortized.

b. Organization costs include expenditures incidental to organizing the business, such as accounting and legal fees, expenses of organizational meetings, and fees paid to the state to obtain a corporate charter.

c. The expenses of issuing stock are not amortizable; they must be netted against the proceeds of the stock sale. These expenses include printing costs, professional fees, commissions, and charges for listing the stock on an exchange.

d. A similar but separate election must be made to amortize **start-up expenses** as well. Start-up expenses are those costs related to the creation of a business prior to the time the activity becomes an active trade or business.

e. Start-up expenditures are any expenditures that would be deductible in the ordinary course of business but instead are classified as start-up as the business has not opened its doors for business.

f. Start-up expenditures occur before the business opens its doors for business.

g. Effective August 16, 2011, a taxpayer can elect to deduct up to $5,000 of business start-up costs as a current business expense. The $5,000 deduction is reduced by the amount the taxpayer's total start-up costs exceed $50,000. Any remaining costs must be amortized ratably over a 180-month period as a Section 197 intangible. Organization costs are amortized separately.

h. A partnership can amortize an organizational cost only if it satisfies all of these five tests:

(1) It is for the creation of the partnership and not for starting or operating the partnership.

(2) It is chargeable to a capital account.

(3) It could be amortized over the life of the partnership if the partnership had a fixed life.

(4) It is incurred by the due date of the partnership return (excluding extensions) for the first tax year.

(5) It is for a type of item normally expected to benefit the partnership throughout its entire life.

Some expenses cannot be amortized (regardless of how the partnership characterizes them), including expenses connected with:

(1) acquiring assets for the partnership or transferring assets to the partnership,

(2) admitting or removing partners other than at the time the partnership is first organized,

(3) making a contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members), and

(4) syndicating the partnership.

4310.13 Example: Organization expenses and start-up costs

A partnership incurs the following start-up costs, opens its doors for business in November, and uses a calendar year for tax purposes.

a. Start-up costs of $4,000: The partnership can immediately deduct $4,000 of start-up expenditures on their first tax return.

b. Start-up costs of $7,000: The partnership can immediately deduct $5,000 of start-up expenditures on their first tax return. The remaining $2,000 ($7,000 total start-up costs less the immediately deducted $5,000) can be capitalized and amortized over 180 months. This represents $11 ($2,000 capitalized costs ÷ 180 months) that can be amortized per month once the doors of the business are open. The business is open two months (the full-month convention is used for amortization) and thus $22 ($11 × 2 months) can be amortized in the partnership's first tax year.

c. Start-up costs of $50,000: The partnership can immediately deduct $5,000 on their first tax return as more than $50,000 of start-up costs have not been incurred. The remaining $45,000 ($50,000 total start-up costs less the $5,000 immediately expensed) can be capitalized and amortized over 180 months. This means that an additional $500 can be amortized in the partnership's first tax year ($45,000 capitalized start-up costs ÷ 180 months = $250 per month of amortization; $250 per month of amortization × 2 months = $500 of amortization).

d. Start-up costs of $52,000: Since start-up costs are in excess of the $50,000 threshold, the maximum $5,000 of immediately expensed start-up costs must be reduced dollar for dollar for amounts in excess of $50,000. The maximum immediately expensed start-up costs are $3,000 ($52,000 total start-up costs – $50,000 threshold = $2,000 over threshold; maximum $5,000 of immediately expensed start-up costs – $2,000 amount in excess of threshold = $3,000). The remaining $49,000 ($52,000 total start-up expenses – $3,000 immediately expensed) is capitalized and amortized over 180 months. This represents $272 per month of amortization of start-up costs ($49,000 ÷ 180 months) and $544 total amortization in the first tax year ($272 per month of amortization × 2 months remaining in the tax year).

e. Start-up costs of $56,000: Since start-up costs are in excess of the phaseout window (immediately expensed start-up costs phase out over $50,000 to $55,000 of start-up costs), none of the costs are immediately expensed. The entire $56,000 is capitalized and amortized over 180 months with $311 amortization per month ($56,000 total capitalized start-up costs ÷ 180 months) and $622 total amortization ($311 per month amortization × 2 months) for the partnership's first tax year.

4320 Cost Recovery (Depreciation and Amortization)

Depreciation

4320.01 A deduction is allowed for wear, tear, exhaustion, and normal obsolescence of property held for the production of income or for property used in a trade or business.

a. This cost recovery process can take the form of depreciation, cost recovery, amortization, or depletion.

b. While depletion relates to natural resources, no depreciation, cost recovery, or amortization is available for the following:

(1) Personal property not used in a trade or business

(2) Inventory

(3) Land

4320.02 For assets acquired after 1986, depreciation is computed using the modified accelerated cost recovery system (MACRS). Under this system, the full cost of the property (including salvage value) is written off over a prescribed recovery period:

a. Revenue Procedure 87-56 sets out a class life, general depreciation system life, and alternative depreciation system life for classes of tangible property used in a trade or business or held for the production of income.

(1) MACRS uses the recovery period.

(2) Class life and alternative depreciation system lives have special purposes not generally affecting calculation of regular taxable income.

b. MACRS depreciation cannot be used for intangible property and property not depreciated in terms of years (units-of-production method).

c. Revenue Procedure 87-57 describes the applicable depreciation methods, applicable recovery periods, and applicable conventions that must be used in computing depreciation allowances under IRC Section 168.

d. **Real estate:**

(1) Under MACRS, real estate acquired after 1986 is depreciated using the straight-line method over the following periods:

Residential real estate	27.5 years
Nonresidential real estate placed in service before May 13, 1993	31.5 years
Nonresidential real estate placed in service after May 12, 1993	39.0 years

(2) Real property acquisitions are subject to the *mid-month convention.* One-half month's cost recovery is allowed in both the month of acquisition and the month of disposition. The MACRS tables take into account the mid-month convention in the year of acquisition, but not in the year of disposition if the real property is not held for its entire recovery period.

(3) The Tax Cuts and Jobs Act of 2017 (TCJA) provides that a real property trade or business electing out of the limitation on the deduction for business interest is required to use ADS (alternative depreciation system) to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.

e. **Personal property:**

(1) There are six recovery periods for personal property—3, 5, 7, 10, 15, and 20 years.

(a) Under MACRS, the 200% declining-balance method is used for the 3-, 5-, 7-, and 10-year properties. The 150% declining-balance method applies to the 15- and 20-year properties. Both methods switch to straight-line depreciation when that method produces a larger deduction.

(b) The 5- and 7-year properties are most common.

i. The 5-year class includes automobiles, general-purpose light trucks, computers, and office machinery (typewriters, calculators, copiers, etc.).

ii. The 7-year class includes heavy, special-purpose trucks and office furniture and fixtures (desks, filing cabinets, etc.).

(2) Generally, a half-year's recovery deduction is taken in the first year of use regardless of the month the property was placed in service (half-year convention). The MACRS tables take the half-year convention into account for the year of acquisition, but not in the year of disposition if the asset is not held for its full recovery period.

(3) Basically, the recovery deduction is determined by applying a prescribed statutory percentage to the unadjusted basis of the property. The government provides tables listing the applicable percentages.

Following is an excerpt of the MACRS table for the half-year convention (recovery period on the horizontal axis, year of cost recovery on the vertical axis):

	3-Year	**5-Year**	**7-Year**	**10-Year**	**15-Year**	**20-Year**
Year 1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
Year 2	44.45	32.00	24.49	18.00	9.50	7.219
Year 3	14.81	19.20	17.49	14.40	8.55	6.677
Year 4	7.41	11.52	12.49	11.52	7.70	6.177
Year 5		11.52	8.93	9.22	6.93	5.713
Year 6		5.76	8.92	7.37	6.23	5.285
Year 7			8.93	6.55	5.90	4.888
Year 8			4.46	6.55	5.90	4.522
Year 9				6.56	5.91	4.462
Year 10				6.55	5.90	4.461
Year 11				3.28	5.91	4.462
Year 12					5.90	4.461
Year 13					5.91	4.462
Year 14					5.90	4.461
Year 15					5.91	4.462
Year 16					2.95	4.461

Note that the 3-year property is cost-recovered over 4 years. This is because in the first and last year of the asset's cost recovery, the half-year convention is used, and thus the asset gets a half-year of depreciation in year 1 and year 4 of the asset's recovery period. This applies to all the other class lives as well.

(4) A mid-quarter convention will apply to property acquired after 1986 if more than 40% of the value of all personal property acquired during a tax year is placed in service during the last quarter of the year.

(a) If the mid-quarter convention applies, property acquisitions must be grouped by the quarter in which they were acquired.

(b) A cost recovery deduction for each of these groups is computed as follows:

Acquisitions	**Depreciation Allowable**
1st quarter	10.5 months
2nd quarter	7.5 months
3rd quarter	4.5 months
4th quarter	1.5 months

These adjustments are built into the MACRS tax tables for the mid-quarter convention. The depreciation-allowable months take into account full quarters in the quarters post the acquisition quarter, and a half-quarter in the acquisition quarter. The assets using the mid-quarter convention will continue to use the mid-quarter convention for the entire time the asset is held. The mid-quarter convention must be taken into account during the acquisition year if the asset is not held for its entire recovery period.

(c) Separate mid-quarter convention tables for personal property are provided by the IRS. There are four tables for use depending on which quarter the asset was placed in service originally: quarter 1, quarter 2, quarter 3, or quarter 4. The same table will be used for the asset's entire recovery period. This means that if an asset is originally purchased in the first quarter, the mid-quarter table for assets placed in service in the first quarter will be used always for the particular asset, even if during the year of disposal the asset is disposed of in another quarter.

Disposition	**Depreciation Allowable**
1st quarter	1.5 months ÷ 12 months = 12.50%
2nd quarter	4.5 months ÷ 12 months = 37.50%
3rd quarter	7.5 months ÷ 12 months = 62.50%
4th quarter	10.5 months ÷ 12 months = 87.50%

(5) Disposal of personal property generally results in a cost recovery deduction in the year of disposal.

(a) In most cases, a half-year of cost recovery is allowed in the year of disposition or retirement.

(b) If the mid-quarter convention applies, the cost recovery will range from 1.5 months to 10.5 months of depreciation depending on in which quarter the disposal of the property takes place. Using the disposition chart above (e.*4(c)*), the depreciation allowable percentage for the quarter of asset disposition is multiplied by the total-year depreciation that would have been allowed had the asset been held for a full year.

(6) The taxpayer may elect to use the straight-line method of depreciation for personal property. This election is available on a class-by-class basis for each tax year.

(7) Under Section 179 of the Internal Revenue Code, the taxpayer, other than an estate, a trust, or certain noncorporate lessors, may elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property or certain real property placed in service during the tax year in the taxpayer's trade or business.

(a) The basis of the asset(s) must be reduced by the amount expensed. The amount "expensed" cannot exceed the taxpayer's aggregate taxable income from trade or business activities. Amounts in excess of trade or business income that would otherwise be deductible are carried forward indefinitely.

(b) Under the Tax Cuts and Jobs Act of 2017 (TCJA), in 2023 a taxpayer may expense up to $1,160,000. The phaseout threshold is now $2,890,000, which means if assets are placed in service above this threshold amount, then the immediate expensing amount is reduced. These amounts are indexed for inflation.

(c) Section 179 property includes tangible property that can otherwise be depreciated using MACRS, computer software, or qualified real property (if elected).

i. Property purchased from a related party is generally excluded.

ii. Qualified real property includes:

a. qualified improvement property (i.e., an improvement to nonresidential real property excluding escalators, elevators, and internal framework).

b. nonresidential real property improvements placed in service after original real property was placed in service, including roofs; heating, ventilation, and air conditioning property; fire protection and alarm systems; and security systems.

(d) The TCJA further clarifies that the cost of roofing; heating, ventilation, and air conditioning property; fire protection and alarm systems; and security systems can be deducted under IRC Section 179 as "qualified real property."

(8) "Bonus depreciation" refers to a special depreciation allowance for the first year that certain classes of property are placed in service.

(9) Under the Tax Cuts and Jobs Act of 2017 (TCJA), bonus depreciation increases from 50% to 100% for property acquired and placed in service (both new and used, so long as the use is new to the taxpayer) after September 27, 2018, and before 2023. After 2023, there is a gradual decrease in the percentage:

(a) 80% for 2023,

(b) 60% for 2024,

(c) 40% for 2025, and

(d) 20% for 2026.

(10) No depreciation is allowed for an asset that is purchased and disposed of within the year.

f. Alternative depreciation system:

(1) After 1986, an alternative depreciation system (ADS) must be used in certain computations.

(a) To compute that portion of depreciation treated as a tax preference item for purposes of the alternative minimum tax for property purchased before 1999

(b) To calculate depreciation for property:

i. Used predominantly outside the United States

ii. Leased or used by a tax-exempt entity

iii. Financed with the proceeds from tax-exempt bonds

iv. Imported from countries engaged in discriminatory practices

v. Listed property used 50% or less in a qualified business use

vi. Certain farming equipment

(c) To compute depreciation for earnings and profits purposes

(2) Generally, depreciation under this method is calculated using the straight-line method without regard to salvage value.

(3) Depreciation of personal property for the alternative minimum tax is calculated by using 150% declining-balance depreciation, switching to the straight-line method when appropriate to maximize deductions.

(4) Depreciation of real estate for the alternative minimum tax uses the mid-month convention.

(5) The recovery period for the ADS, while generally the ADR midpoint life of an asset, is provided for every asset's class in Revenue Procedure 87-56.

(6) Taxpayers may elect to use ADS in lieu of MACRS.

(7) Required to be used by electing real estate trade or businesses who wish to opt out of the interest deduction limitation under IRS Code Section 163(j).

g. The government publishes tables that automatically provide for each of the special conventions that a taxpayer may use in the year of acquisition for both real estate and personal property.

h. Listed property:

(1) Special rules apply to property suitable for both business and personal use (only automobiles after the Tax Cuts and Jobs Act of 2017 (TCJA)).

(a) If business usage of such property is not more than 50%, the property does not qualify for regular (accelerated) MACRS, bonus, or the Section 179 first-year expense. It must be depreciated over ADS life using the straight-line method.

(b) If business usage exceeds 50%, the property is available for regular MACRS, additional first year depreciation (bonus depreciation), and Section 179 depreciation. If future business usage drops below 50%, a permanent switch to the straight-line method is required. In addition, previous cost recoveries in excess of straight-line depreciation must be recaptured as additional income.

(2) An additional limitation is placed on so-called "luxury automobiles." A dollar limit for depreciation is mandated for each year the car is in use. For tax years beginning after 2017, these limits will be adjusted for inflation using the automobile component of the consumer price index (CPI). The automobile is deemed "luxury" if, after calculating the depreciation, the limit applies. The luxury classification is not determined by the quality of the car, the finish on the car, etc.

(a) For passenger automobiles acquired after September 27, 2017, the Tax Cuts and Jobs Act of 2017 (TCJA) increased allowable depreciation for a passenger automobile in lieu of bonus depreciation or a Section 179 amount as follows (limits applicable for 2023):

Year 1	$12,200
Year 2	19,500
Year 3	11,700
Year 4 and after	6,960

If **bonus depreciation is claimed**, then the applicable limits for 2023 are:

Year 1	$20,200
Year 2	19,500
Year 3	12,700
Year 4 and after	6,960

(b) These limits must be reduced proportionately if business usage is less than 100%. The limits are multiplied by the business-use percentage to calculate the applicable limit for a particular automobile.

(c) Trucks, SUVs, and vans weighing over 6,000 pounds are not subject to the luxury automobile limits. Likewise, ambulances, hearses, taxis, and limousines are not subject to these limits. Certain particularly heavy automobiles may also weigh in excess of this limit and are thus not subject to depreciation limits that are applicable to lighter automobiles.

Example: An automobile weighing less than 6,000 pounds is purchased and is used 80% for business this year. The half-year convention applies and the asset was purchased for $50,000. The maximum depreciation that can be claimed this year on an automobile used 80% for business if bonus depreciation is not claimed is $8,960 ($11,200 limit × 80% business use percentage). Next, the depreciation is calculated normally as the automobile is used more than 50% for business. Automobiles have a 5-year recovery period. The depreciation before considering the maximum limit is calculated as $50,000 purchase price × 20% applicable MACRS rate × 80% business use = $8,000. This amount is less than the limit, so the full $8,000 can be taken. Thus, the automobile is not a luxury automobile as the limit is not reached.

Assume the same scenario as above except the automobile cost $80,000. The calculated depreciation before the limits are considered is $12,800: $80,000 purchase price × 20% applicable MACRS rate × 80% business use. This is above the limit, and thus only $8,960 of depreciation can be taken on this automobile this year (when no bonus depreciation is claimed). This would be considered a luxury automobile as the maximum depreciation amount has been reached.

Recovering the Cost of Leasehold Improvements and Intangible Assets

4320.03 Improvements made by the lessee that are made in lieu of rent are deductible as rent by the lessee and included as income by the lessor.

4320.04 Improvements made by the lessee that are *not* made in lieu of rent must be capitalized by the lessee and written off using the modified accelerated cost recovery system (MACRS).

4320.05 Taxpayers generally amortize the cost of intangibles acquired after August 10, 1993, over a 15-year period on a straight-line basis, beginning with the month acquired.

a. Section 197 intangibles are a qualifying asset acquired and held in connection with the conduct of a trade or business. This includes goodwill, going-concern value, trademarks, and franchises.

b. Copyrights, patents, and covenants not to compete are included when acquired with the purchase of a business.

c. Intangibles not required to be written off over 15 years are amortized over their useful lives. Such assets include copyrights and patents acquired separately, not acquired with the purchase of a business.

d. Interests in land, financial interests, computer software, mortgage servicing, and leases of tangible personal property are excluded from the definition of Section 197 intangibles.

e. A loss cannot be recognized on the disposition of Section 197 intangibles if the taxpayer retains other Section 197 intangibles acquired in the same transaction.

f. Research and experimental expenditures may be (1) expensed in the year paid or incurred, (2) capitalized and amortized over a period of time not less than 60 months, or (3) capitalized and amortized ratably over 10 years and thereby avoiding alternative minimum tax considerations.

Depreciation and Recovery Allowance Recapture

4320.06 Whereas IRC Section 1231 provides long-term capital gain treatment for certain noncapital assets, IRC Sections 1245 and 1250 may deny this special treatment where the gain represents a recovery of some or all of the depreciation allowances previously deducted. IRC Sections 1245 and 1250 take precedence over IRC Section 1231.

4320.07 **Section 1245 recapture:**

a. IRC Section 1245 requires that any gain on IRC Section 1245 property will be treated as ordinary income to the extent of *all* depreciation taken. Thus, the Section 1245 recapture as ordinary income is the lesser of depreciation taken on the property or the gain realized.

b. Any gain on IRC Section 1245 property which is not recaptured as ordinary income becomes IRC Section 1231 gain. Section 1231 gain is netted with Section 1231 losses and ultimately is taxed as capital gain if net gain results, and ordinary loss if net loss results.

c. IRC Section 1245 property refers primarily to equipment used in a trade or business. It also includes most buildings acquired during the ACRS (accelerated cost recovery system) recovery period (1981–1986). Section 1245 property includes tangible depreciable personal property.

d. Depreciation recapture rules do not apply when property is disposed of by gift or by transfer at death.

e. Gift property retains its ordinary income potential in the hands of the donee.

f. The charitable contribution deduction for Section 1245 property must be reduced by the amount that would have been recognized as ordinary income if the item had been sold at its fair market value.

g. In tax-free exchanges and involuntary conversions of Section 1245 property, depreciation recapture is considered only to the extent that a gain is recognized on the exchange or conversion. Depreciation recapture never applies to losses.

h. Any depreciation recapture resulting from an installment sale is to be recognized in the year of sale even if no proceeds are received. Gains taxed as ordinary income, of which Section 1245 gains are included, are specifically excluded from gains eligible to receive installment sale treatment.

i. IRC Section 1245 recharacterizes some or all of the gain from receiving Section 1231 treatment to receiving ordinary gain treatment, but the provision does not change the total gain that is to be recognized.

j. **Example:** Over the years, $10,000 of MACRS depreciation was taken on a piece of equipment costing $30,000. If this property is sold for $25,000, a gain of $5,000 results

($25,000 – ($30,000 – $10,000)). The business must recognize all $5,000 (lesser of depreciation taken ($10,000) or gain recognized ($5,000)) of this gain as ordinary income under IRC Section 1245.

Amount realized		$25,000
Less: Adjusted basis		
Cost	$30,000	
Less: Straight-line depreciation	(10,000)	(20,000)
Realized gain		$ 5,000
Recognized gain:		
As ordinary income, Section 1245:		
Lesser of $10,000 or $5,000		$ 5,000
As Section 1231 long-term capital gain		0
Total recognized gain		$ 5,000

4320.08 Section 1250 property rules:

a. IRC Section 1250 applies to real property—buildings and their structural components.

b. IRC Section 1250 requires that excess depreciation (actual depreciation in excess of straight-line depreciation) be recaptured as ordinary income. However, this provision no longer applies since straight-line depreciation has been required on buildings acquired after 1986. Thus, there is no excess depreciation, and all of the depreciation is "unrecaptured."

c. The unrecaptured gain on the sale of a building becomes IRC Section 1231 gain. If Section 1231 gains exceed Section 1231 losses for the current and past five years, the remaining gain receives long-term capital gain treatment. However, unrecaptured Section 1250 gain may be taxed at a special rate of 25% for noncorporate taxpayers.

(1) Unrecaptured Section 1250 gain is equal to the lesser of the gain or the total depreciation taken on the property.

(2) Any gain not treated as unrecaptured Section 1250 gain (excess of sales price over cost before depreciation) is taxed at the long-term capital gain rate applicable to the transaction based on the taxpayer's tax bracket.

(3) The unrecaptured IRC Section 1250 gain for noncorporate taxpayers is taxed at a maximum rate of 25%. If the individual's marginal ordinary income rate falls below 25%, then the unrecaptured IRC Section 1250 gain would be taxed at the lower ordinary rate instead of the 25% rate.

(4) The unrecaptured IRC Section 1250 gain can offset other capital losses for noncorporate taxpayers.

Example: A commercial building acquired at a cost of $2,028,000 was sold in 2023 for $3 million after deducting straight-line depreciation of $650,000 over the years. Assuming that no other Section 1231 events affect this transaction and assuming the taxpayer is a noncorporate taxpayer, the taxation of the $1,622,000 gain is as follows.

Because straight-line depreciation was used, no depreciation is recaptured as ordinary income. Consequently, there is unrecaptured Section 1250 gain of $650,000. This portion of the gain is taxed at a maximum of 25%. The remaining gain of $972,000 is taxed at 20%, assuming the taxpayer is an individual with taxable income in excess of $434,550.

Amount realized		$3,000,000
Less: Adjusted basis		
Cost	$2,028,000	
Less: Straight-line depreciation	(650,000)	(1,378,000)
Realized gain		$1,622,000
Recognized gain:		
As ordinary income		$ 0
As unrecaptured Section 1250 gain taxed at 25% rate		650,000*
As Section 1231 long-term capital gain taxed at 20% rate		972,000
Total recognized gain		$1,622,000

* Note the distinction between **ordinary income recapture** versus **unrecaptured 1250 gain.** The first one applies to excess of accelerated method and uses ordinary rates, whereas the second one is the straight-line depreciation recapture, taxed at 25%. Also note that the 25% rate is the maximum rate the unrecaptured Section 1250 gain would be taxed. If the taxpayer's ordinary marginal tax rate is less than 25%, then the unrecaptured Section 1250 gain would be taxed at this lower ordinary tax rate.

d. Additional rule for C corporations (IRC Section 291):

(1) A C corporation's ordinary income from the sale of IRC Section 1250 real property will be increased by 20% of the lesser of (1) depreciation taken or (2) the recognized gain.

Example: Over the years, $30,000 of straight-line depreciation was taken on a building costing $100,000. If this property is sold for $110,000, a gain of $40,000 results ($110,000 – ($100,000 – $30,000)). The corporation must recognize $6,000 ($30,000 × 20%) of this gain as ordinary income under IRC Section 291.

Amount realized		$110,000
Less: Adjusted basis		
Cost	$100,000	
Less: Straight-line depreciation	(30,000)	(70,000)
Realized gain		$ 40,000
Recognized gain:		
As ordinary income, Section 291:		
Lesser of: $30,000 × 0.20 = $6,000		
or $40,000 × 0.20 = $8,000		$ 6,000
As Section 1231 long-term capital gain		34,000
Total recognized gain		$ 40,000

(2) This provision does not affect Subchapter S corporations.

(3) C corporations are not taxed at different rates on ordinary income or capital gain income. Section 1231 gains are ultimately taxed as capital gains if they are not recaptured or offset by Section 1231 losses. The benefit of capital gain treatment as opposed to ordinary income treatment is that capital losses can be used to offset the capital gains. Capital losses can only be taken to the extent of capital gains, so capital losses may be limited. Ordinary losses can offset any income on the tax return and are thus not subject to the same level of restriction as capital losses.

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Section 4400
Federal Taxation of Individuals
(22%–32%)

4410 Gross Income (Inclusions and Exclusions)

4411 Inclusions and Exclusions

4411.01 **Gross income** is all income from whatever source, except for those items that are specifically excluded by the Internal Revenue Code.

a. Gains are included in gross income in the year in which the gain is realized as determined by the taxpayer's accounting method (cash or accrual basis).

(1) Cash-basis taxpayers report income when they actually or constructively receive cash or property.

(2) Taxpayers using the accrual method of accounting report income in the year when the right to the income becomes fixed and the amount can be determined with reasonable accuracy.

(a) If reported income is properly accrued on the basis of a reasonable estimate and, in a subsequent year, the exact amount is higher than estimated, the difference is reported as income in the year that such a determination is made.

(b) An amended return is not required.

b. Income received in advance is generally taxed in the year in which it is received, even though the accrual basis is used.

c. Mere appreciation in the value of property is **not** considered income. The property must be converted into cash or other property before a gain is realized.

4411.02 In computing gross income, the taxpayer faces two problems:

1. Recognizing potential income items

2. Identifying those income items specifically excluded by law

4411.03 **Health insurance costs:**

a. Self-employed taxpayers may deduct 100% of the medical insurance premiums paid for themselves and their families. Included are premiums for certain long-term care insurance contracts and/or Part B/D Medicare premiums. This deduction cannot exceed the net earnings from the business. IRC Section 213(d)(10)(A) provides for limitations on the amount of eligible long-term care insurance premium deduction allowed per person based on age at the end of the year.

b. No deduction is available to those self-employed taxpayers who are eligible to participate in an employer's subsidized health insurance program. The employer may be the employer of the taxpayer or the spouse.

c. Where medical insurance premium deduction is limited due to net earnings limitations, the remainder of the medical insurance premiums is available as an itemized medical expense deduction, subject to 7.5% of adjusted gross income limitation. The 7.5% adjusted gross income limitation has been made permanent by the Consolidated Appropriations Act, 2021 (CAA).

d. Taxpayers who are not otherwise covered by health insurance may choose to establish a health savings account (HSA). Contributions to such accounts are fully deductible if the account meets a number of requirements and limitations. HSA accounts can operate in concert with high-deductible health plans, and allowable limits and contributions change annually.

e. For 2023, HSA contribution limits are $3,850 for an individual and $7,750 for a family. If you are 55 or older, you can contribute an extra $1,000 per year.

f. The term "high-deductible health plan" means, for self-only coverage, a health plan that for 2023 has an annual deductible that is not less than $1,500 ($3,000 for a family) and under which the annual out-of-pocket expenses required to be paid for covered benefits do not exceed $7,500 ($15,000 for a family). These numbers are usually updated annually for inflation.

4411.04 Military combat pay:

a. U.S. Armed Forces members, including enlisted persons or warrant officers, may exclude military pay received for military services for the entire month of any month while serving in a combat zone. Commissioned officers are capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received.

b. Military pay received by enlisted personnel who are hospitalized as a result of injuries sustained while serving in a combat zone is excluded from gross income for the period of hospitalization.

c. Reenlistment bonuses received are excluded from gross income if the member reenlists early while in a combat zone even if the bonus is not received until several months later while stationed outside the combat zone.

d. Deadlines, including filing and paying income tax due, are automatically extended for service persons in a combat zone.

4411.05 Roth IRAs

a. Distributions from a qualified Roth IRA will be tax-free and penalty-free if the distributions are made:

(1) five years or more after the first contribution was made, and

(2) on or after the date the taxpayer attains age 59-1/2, or

(3) to a beneficiary or estate as a result of the taxpayer's death, or

(4) on account of the taxpayer's permanent and total disability, or

(5) for first-time homebuyer expenses ($10,000 limit), or

(6) for a qualified birth or adoption ($5,000 limit per individual or $10,000 limit for married couples filing a joint return), or

(7) for qualified disaster distributions, or

(8) for distributions made as part of a series of substantially equal periodic payments (made at least annually) for the taxpayer's life (or life expectancy, using IRS tables) or the joint lives of the taxpayer and their designated beneficiary (if payments are made from an employer plan, payment must begin after separation from service), or

(9) for distributions made to certain unemployed individuals for health insurance premiums.

b. When distributions do not meet the criteria, amounts received in excess of contributions will be included in gross income and taxed. A 10% early withdrawal penalty will also apply to the taxable amount. Note that contributions are returned before any earnings are distributed with a Roth IRA.

c. Setting up a Roth IRA:

(1) For 2023, taxpayers who qualify may make nondeductible contributions of up to $6,500 each year to a Roth IRA. A qualifying taxpayer over age 50 may add $1,000 to that amount for a total contribution of $7,500. That $1,000 is referred to as a "catch-up amount."

(2) There is no age limit on contributions to a Roth IRA.

(3) Distributions before death are not required.

(4) Contribution limits (covered by a retirement plan at work):

(a) The 2023 contribution limit of $6,500 ($7,500) is phased out proportionately between the following AGI levels:

i. Singles and head of households: $138,000–$153,000

ii. Joint filers: $218,000–$228,000

iii. For 2023, for a married individual filing a separate return, the phaseout is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

(b) For 2023, the limit for total contributions to Roth IRAs and traditional IRAs combined is $6,500 ($7,500) (before phaseouts), not counting rollover contributions.

d. Rollover contributions:

(1) Funds in one Roth IRA can be rolled over tax-free to another Roth IRA.

(2) Funds in a traditional IRA can be rolled over penalty tax-free to a Roth IRA, but income tax must be paid on the distribution from the traditional IRA. However, the rollover is tax-free only if the taxpayer is not married filing a separate return.

(3) Rolling a traditional IRA to a Roth IRA is called conversion. If the Roth was rolled back into a traditional IRA, the process was called a recharacterization. Before the Tax Cuts and Jobs Act of 2017 (TCJA), it was possible to recharacterize a contribution (IRA-ROTH-IRA) by trustee-to-trustee transfer. Under the TCJA, recharacterizations are repealed.

4411.06 Retirement plans

a. Self-employed persons may deduct up to $66,000 in 2023 for contributions to a qualified retirement plan (Keogh plan). Simplified employee pension (SEP) IRAs have similar limits and have replaced the Keogh plan among all but high-income professionals who established Keogh plans over a decade ago.

(1) For 2023, the deduction cannot exceed 25% of earned income.

(2) Earned income is income after the retirement contribution has been deducted.

(3) Additional earnings may be transferred to a Keogh plan (but not to a SEP IRA) with no resulting tax deduction (after tax).

b. For 2023, taxpayers may contribute (and deduct) up to $6,500 ($7,500 if over age 50) to a traditional individual retirement account (IRA), and this may equal up to 100% of their earned income. Included as acceptable investments are coins and bullion of gold, silver, and platinum, but not collectibles (e.g., stamps and antiques).

(1) For plans established to include a nonworking spouse, the deduction ceiling of $6,500 ($7,500 if over age 50) applies to each spouse, permitting a total of $13,000 to be deducted from their joint taxable income ($15,000 if both are age 50 or over). However, the contribution cannot exceed the sum of their earned incomes.

(2) Alimony, if included in income, is treated as compensation for purposes of calculating allowable contributions to an IRA.

(3) Taxpayers who are active participants in an employer-sponsored retirement plan or Keogh plan face an IRA deduction phaseout.

(a) For 2023, the phaseout takes place when AGI falls within these ranges:

		2023 MAGI
i.	Single taxpayers and Heads of household	$73,000–$83,000
ii.	Married filing jointly	$116,000–$136,000
iii.	Married filing separately	$0–$10,000

(b) One spouse's active participation in an employer-sponsored plan will not disqualify the other spouse from making deductible IRA contributions.

(c) The maximum $6,500/$13,000 IRA deduction is phased out proportionately for each dollar of AGI that falls within the phaseout range.

(d) Taxpayers with AGI above the phaseout range may still contribute up to $6,500/$13,000 to an IRA.

i. These contributions will be *nondeductible.*

ii. The earnings on such contributions will be tax-free until withdrawals are made from the IRA.

iii. This program continues as an option to the Roth IRA.

(e) The limit for total contributions to all retirement IRAs combined is $6,500, before phaseouts, for each individual. This amount increases by $1,000 if "catch-up" contributions are involved.

(4) There is no maximum age for traditional IRA contributions in tax years after 2019.

(5) **Qualified charitable distributions (QCD)**: Taxpayers who are over age 70-1/2 are permitted to make a "qualified charitable distribution" of up to $100,000 *directly* from an IRA to a charity.

(a) The contribution to the charity is not claimed as a tax deduction; the age for QCDs remains 70-1/2 (even as the required minimum distribution age rises to 72).

(b) The QCD counts toward the taxpayer's required minimum distribution (RMD) obligations. Funds must be transferred directly from the IRA account to the charitable organization. Not all charitable organizations qualify (examples include, donor-advised funds, private foundations, and supporting organizations).

(c) QCDs are deemed to be first in the order of distributions, from any untaxed gain in the IRA, so that the QCD does not reduce the taxpayer's basis. This allows future distributions to the taxpayer to be tax-free to the extent there is basis in the IRA.

(d) Beginning in 2020, QCDs are reduced by the aggregate deductible IRA contributions made by an individual age 70-1/2 and older in an effort to curb potential abuse.

(e) The PATH Act of 2015 made the QCD rules permanent, at their existing levels and thresholds (still capped at $100,000 per taxpayer, and the taxpayer must still be over age 70-1/2 at the time of the distribution).

(6) Taxation of distributions:

(a) Distributions from a traditional IRA are generally taxable. However, taxpayers making nondeductible contributions to their accounts may withdraw these contributions tax-free using the rules for annuity proceeds.

(b) Taxpayers receiving distributions before age 59-1/2 are subject to an additional 10% penalty on the taxable portion of the distribution. This penalty will not apply when the distribution is as follows:

i. Due to a death or disability

ii. Used to pay deductible medical expenses

iii. Used by an unemployed person to buy health insurance

iv. Used to pay qualified higher education expenses

v. Used to pay expenses of a qualified first-time homebuyer

a. There is a $10,000 lifetime limit.

b. A first-time homebuyer is one who has not owned a principal residence in the past two years.

vi. Used to pay for a qualified birth or adoption: There is a $5,000 limit per individual or $10,000 limit for married couples filing a joint return.

(c) Taxpayers must start withdrawing IRA funds no later than April 1 of the year after turning age 72 (age 70-1/2 if the taxpayer reached 70-1/2 before January 1, 2020). Required minimum distributions (RMD) must be taken annually. If there are no distributions, or if the distributions do not equal or exceed the minimum required distribution amount, the taxpayer incurs a 50% excise tax on the amount not distributed as required.

c. SIMPLE retirement plan for small businesses:

(1) **The Savings Incentive Match Plan for Employees (SIMPLE)** simplifies complexities of retirement plans.

(a) The amount an employee contributes from his or her salary to a SIMPLE IRA cannot exceed $15,500 in 2023. See *(c)* below regarding an additional $3,500 contribution permitted for employees age 50 or over.

(b) If an employee participates in any other employer plan during the year and has elective salary reductions under those plans, the total amount of the salary reduction contributions that an employee can make to all the plans he or she participates in is limited to $22,500 in 2023.

(c) If permitted by the SIMPLE IRA plan, participants who are age 50 or over at the end of the calendar year can also make catch-up contributions. The catch-up contribution limit for SIMPLE IRA plans is $3,500 in 2023.

(2) SIMPLE plans can be adopted by employers having 100 or fewer employees.

(a) The employee must not be part of another employer-sponsored retirement plan.

(b) All contributions are fully vested immediately.

(c) Employee contributions are deductible for AGI, and taxation on accumulations is deferred until distributed.

(3) **Caution:** Distributions before age 59-1/2 are subject to an additional tax of 10% (25% if taken during the two-year period beginning on the date the individual first participated in any SIMPLE IRA plan of the employer). Exceptions include distributions for the following:

(a) Death

(b) Disability

(c) Deductible medical expenses

(d) Health insurance of an unemployed individual

(e) Qualified higher education expenses:

i. Include tuition, fees, books, supplies, equipment, and room and board for postsecondary education (includes graduate-level courses)

ii. Apply to taxpayer, spouse, children, and grandchildren

iii. Expenses are reduced by scholarships and similar excludible funding.

(f) First-time homebuyer expenses ($10,000 limit)

(g) Qualified birth or adoption ($5,000 limit per individual or $10,000 limit for married couples filing a joint return)

4412 Characterization of Income

4412.01 A complete list of potential income items and exclusions is impossible. Many items can only be identified as includible or excludible after the facts of the individual case have been examined. This portion of the tax review lists selected items that are frequently encountered.

4412.02 Alimony and separate maintenance payments:

Note: The Tax Cuts and Jobs Act of 2017 (TCJA) changes the treatment of alimony and separate maintenance payments negotiated **after** December 31, 2018. (See *(f)* below.)

a. Excluding the portion that is designated for child support, “qualified payments” are included in the gross income of the recipient and deductible from gross income by the payor if the payments are made after:

(1) decree of divorce or separate maintenance,

(2) written separation agreement, or

(3) decree for support (this applies to periods pending finality of divorce or legal separation).

b. "Qualified payments" (pursuant to a divorce decree or separate maintenance agreement in force before December 31, 2018) are required to meet the following guidelines:

(1) Payments must be in cash.

(2) Payments must terminate at the death of the recipient.

(3) Payments cannot be made to a payee who lives in the same household as the payor.

(4) Payments cannot be specified as something other than alimony.

c. Special rules apply if alimony payments in the second or third year decrease by more than $15,000 from the payments made in the previous year.

(1) If the change in payments exceeds statutory limits, recapture of excessive alimony payments will result.

(2) All of the recapture will take place in the third year.

(a) The payor must include the excess amounts in gross income.

(b) The payee is allowed to deduct the excess payments from gross income to arrive at adjusted gross income.

d. Any amount that can be identified as *child support* cannot be treated as alimony.

(1) Child support payments are neither deductible by the payor nor income to the recipient.

(2) If both child support and alimony are provided for in the agreement, any amounts paid are first considered to be child support until that obligation is met.

e. The transfer of property between divorcing spouses in exchange for release from marital obligations is nontaxable. The basis of the transferred property to the transferee will be the same as it was to the transferor.

f. Noncash property settlements, payments used to keep up the payer's property, or use of the payer's property are **not** considered alimony.

g. For any divorce or separation agreement executed after December 31, 2018 (*not* 2017), or executed before that date but modified after it (if the modification expressly provides that the new amendment applies), alimony and separate maintenance payments are not deductible by the payor spouse nor includible in income of the payee spouse.

4412.03 Annuity proceeds:

a. The taxpayer may exclude from income the portion of any annuity proceeds that represents the recovery of the taxpayer's previously taxed investment. Excess proceeds are included in gross income.

b. To determine the portion of annuity proceeds that is excluded from gross income, an exclusion ratio is applied against the amount received:

$$\frac{\text{Taxpayer's investment in contract}}{\text{Total expected return on contract}} \times \text{Amount received}$$

(1) Life expectancy tables (annuity tables) are used to compute the expected return on the contract.

(2) The exclusion ratio, once computed, does not change. It is used each year until the taxpayer's total investment in the annuity is recovered. Additional receipts are fully taxed.

c. For qualified retirement plan annuities, a different procedure applies:

$$\frac{\text{Taxpayer's investment in contract}}{\text{Number of anticipated monthly payments}} = \text{Amount excluded}$$

(1) The number of anticipated monthly payments is determined from the following table:

Age of Annuitant on Annuity Starting Date	Number of Anticipated Monthly Payments
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

(2) The number of payments requires adjustment when the annuity payments are not made on a monthly basis. For example, if the number of payments is fixed, the number of payments becomes the denominator.

d. In *b.* and *c.* above, the "taxpayer's investment" includes only nondeductible (fully taxed) amounts invested.

e. If the annuitant dies before the total investment is recovered, the remaining investment is deductible as an itemized deduction on the decedent's final return.

4412.04 Bargain purchase:

a. Property purchased at a cost less than market value by an employee or shareholder is a bargain purchase.

b. The difference between fair market value and purchase price may be income to the purchaser at the time of purchase. Any amount included in the taxpayer's income will increase basis in the acquired property.

c. Generally, property purchased by an employee under an employee discount policy does not constitute a bargain purchase. However, certain employee discounts may create income under the bargain purchase provisions.

(1) If the discount is for merchandise, the excludible amount cannot exceed the selling price of the item to the public multiplied by the employer's gross profit percentage.

(2) If the discount is for services, the discount exclusion is limited to 20% of the price at which it is offered to the public.

4412.05 Bequests:

a. The value of property received by bequest, devise, or inheritance is excluded from gross income.

b. Income produced by such property is taxable.

4412.06 Canceled debt:

a. Generally, a canceled debt is income to the debtor when the cancellation is not intended to be a gift.

b. The presence or absence of consideration is a vital factor in determining whether or not a gift was intended.

c. When a seller cancels a buyer's purchase indebtedness, the buyer can generally avoid income recognition by electing to reduce the basis of the property by the amount of the debt discharged.

d. Discharge of indebtedness due to debtor insolvency or federal bankruptcy law is generally not included in gross income but is used instead to reduce the basis of assets or other items carrying favorable tax attributes, such as loss or credit carryovers. Discharge of indebtedness of Paycheck Protection Program (PPP) loans will not be included in gross income, will not reduce tax attributes, and will be treated like tax-exempt income for purposes of computing the shareholder/member tax basis and S corporation accumulated adjustments account/other adjustments account (AAA/OAA).

e. For purposes of determining income from forgiveness of indebtedness (canceled debt), debtor insolvency is measured at the time of an "identifiable event." Identifiable events are reported to the debtor in the Form 1099-C, *Cancellation of Debt,* that reports the debt forgiveness amount.

f. A shareholder's cancellation of a corporation's indebtedness is treated as a contribution of capital.

g. Some *states* make loans to students under an agreement that the loan will be canceled if the student works in a certain profession, in a location within the state after graduation.

(1) The canceled debt is excluded from gross income.

(2) This exclusion also applies to loans from tax-exempt charitable organizations. However, the debt cancellation cannot relate to services performed for the lender organization.

(3) The Tax Cuts and Jobs Act of 2017 (TCJA) excludes any income resulting from the discharge of student debt due to death or disability for discharges of student loans after 2017 and before 2026.

(4) The American Rescue Plan Act of 2021 (ARPA) expands the student loan debt exclusion to exclude from gross income certain discharges of student loans after December 31, 2020, and before January 1, 2026. The expanded student loan discharge exclusion applies to the following:

(a) Private education loans

(b) Loans provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by the United States, a state or local governmental entity, or an eligible educational institution

(c) Loans made by an educational organization qualifying as a 50% charity

(d) Loans made by an educational organization qualifying as a 50% charity or by a tax-exempt organization to refinance a loan to an individual to assist the individual in attending any educational organization, but only if the refinancing loan is under a program of the refinancing organization that is designed as described in item *(c)* above

4412.07 Child support:

a. Amounts received as child support are not included in income of the recipient.

b. Child support cannot be deducted by the payor but may be used to measure support for a possible dependency exemption under pre-1985 agreements.

4412.08 Childcare facilities:

a. The value of child and dependent care services provided by the employer are excludible up to $5,000 per year ($2,500 for married persons filing separately). Employer-provided amounts that are used to cover qualified childcare expenses will not be included in gross income but will also be excluded from qualifying expenses for purposes of calculating the qualified child and dependent care credit (no double benefit).

b. The exclusion cannot exceed the taxpayer's earned income or, if married, the earned income of the spouse with the lesser amount of earned income.

4412.09 Damages collected:

a. Compensatory damages received under a suit for physical injury or sickness are excluded from income.

b. Punitive damages and damages for loss of profits are income.

4412.10 Dividends of cash or property:

a. Dividends are distributions of cash or property from corporations to their shareholders. Generally, dividends are taxable when received. However, some distributions may be tax free, depending on a calculation of earnings and profits (E&P) by the distributing corporation. Federal law requires a corporation to inform the shareholder as to taxable and nontaxable amounts.

b. For individuals in 2023 there is a 0% tax on dividends when taxable income is $44,625 or less, a 15% rate for individuals up to $492,300, and a rate of 20% for individuals above that amount. For joint filers, those amounts are $89,250 and $553,850; for heads of household, the amounts are $59,750 and $523,050.

c. For individuals there is an additional 3.8% Medicare contribution tax on the lesser of net investment income or the modified adjusted gross income (MAGI) for the year over a threshold amount. The threshold amount for 2023 is $250,000 for joint returns, $125,000 for married filing separate returns, and $200,000 for other filing status.

d. If the taxpayer has a choice of stock or cash:

(1) any cash received is income.

(2) any stock received is income to the extent of the fair market value of the stock on the date received.

(a) The basis of the new stock is also the fair market value of the stock.

(b) The holding period for the new stock begins on the date the dividend is received.

e. Stock dividends that do not result in a disproportionate distribution are not considered income. Likewise, stock splits do not produce income for the shareholders.

(1) The basis of original shares must be allocated between the new and the original shares.

(2) The holding period of the acquired stock is the same as that of the old stock.

f. Any distribution of stock or stock rights made to preferred shareholders is taxable as a dividend.

(1) The fair market value of the property received constitutes income and establishes the basis of that property.

(2) The holding period for this property begins at the date of receipt.

g. Property received as a dividend is income.

(1) The fair market value of the property on the date of distribution constitutes income.

(2) The basis of the property is also equal to the fair market value.

(3) The holding period of the property acquired begins on the date the property is received.

h. Amounts received in a partial or complete liquidation are treated as follows:

(1) A return of capital *until* the taxpayer's investment is recovered

(2) A capital gain on amounts received after the taxpayer's investment is recovered

4412.11 **Employee death benefit:** Employer payments to the employee's survivors will be taxed unless the payment qualifies as a gift.

4412.12 **Farming income:**

a. The cash-basis farmer includes in gross income all cash receipts and the value of all property received from the sale of livestock and produce raised or bought for resale. Income received from any other source **that is related to the farming business** is also included.

(1) Crop insurance proceeds may be included in the next year's income if the taxpayer can prove that the destroyed crop's income would have been included in next year's income.

(2) The Tax Cuts and Jobs Act of 2017 (TCJA) reduced the recovery period for any machinery or equipment used in a farming business (other than any grain bin, cotton ginning asset, fence, or other land improvement) the original use of which begins with the taxpayer and is placed in service after December 31, 2017, from seven years to five years.

The TCJA also repealed the required use of the 150% declining-balance method for property used in a farming business except for any 15- or 20-year property used in the farming business to which the straight-line method does not apply, or to property for which the taxpayer elects the use of the 150% declining-balance method.

(3) Income from sale of a crop should be included in the year the crop is sold. The farmer may have pledged his crop to secure a Commodity Credit Corporation loan; the farmer may then report the crop sold for the loan proceeds in the year the cash is received rather than when the crop is sold to satisfy the loan.

b. Schedule F (IRS Form 1040, *Farm Income and Expenses*) is the schedule that all farmers must file to report their income from agricultural activities. Schedule SE is also needed for the computation of self-employment tax. Other schedules such as related taxable capital gain or loss may apply to farmers as well.

c. The accrual-basis farmer computes gross income from farming as follows:

	Ending inventory of produce and livestock raised or purchased for sale
+	All farming receipts for the year
–	Beginning inventory of the products and livestock held for resale
–	Cost of inventory items purchased during the year
=	Gross income from farming

d. Farming income is taxed the same as income from any other business.

4412.13 Gambling winnings and losses:

a. All gambling winnings are included in gross income.

b. Losses are deductible as an itemized deduction not subject to the 2%-of-AGI threshold, but only to the extent of winnings. Under the Tax Cuts and Jobs Act of 2017 (TCJA), the law is clarified: for example, an individual's expenses traveling to and from a casino are only deductible to the extent of gambling winnings. That is, there is no separate deduction for expenses incurred in winning the gambling income.

4412.14 Gifts:

a. For 2023, the first $17,000 of gifts to any person is not included in the total amount of taxable gifts made during the year.

b. For 2023, the first $175,000 of gifts to a spouse who is not a U.S. citizen is not included in the total amount of taxable gifts made during the year.

c. For 2023, the "lifetime limit" on gifts not subject to the gift tax is $12.92 million for a single individual and $25.84 million for a married couple.

d. Income generated by property received as a gift is taxable.

e. If the taxpayer sells an asset that they previously received as a gift, any gain is also taxable. The gain is calculated as the amount realized (everything received of value less any selling costs) less the tax basis of the asset. For items received as gifts that are subsequently sold for a gain, the tax basis is the same as the basis the donor had in the gift.

4412.15 Group-term life insurance:

a. When the employer pays the premiums on nondiscriminatory group-term life insurance for its employees, the cost of insurance coverage in excess of $50,000 is considered income to the employee.

b. *Any* amount paid by the employee for the group-term life insurance can be used to reduce this income.

c. A group-term life insurance plan is nondiscriminatory if it benefits 70% or more of all employees and at least 85% of all employees who are participants under the plan are not key employees.

4412.16 Employer contributions to a health savings account:

a. Within limits, employer contributions to an employee's health savings account (HSA) are excluded from the employee's income.

b. Both employer and employee contributions are combined to determine the maximum allowable contribution.

c. Contributions to an HSA are limited:

(1) For 2023, the maximum contribution amount is $3,850 for self-only coverage and $7,750 for family coverage, with an additional $1,000 allowed if age 55 or older.

(2) Employer contributions to an employee's HSA are excluded from income. However, both employer and employee contributions are combined to determine the maximum allowable contribution.

4412.17 Health care flexible spending accounts (FSAs):

a. A taxpayer's employer's plan can allow a $610 carryover balance to the following year for money not used for allowed purposes, or

b. Allow a grace period through March 15 of the following year.

c. For 2023, the dollar limit on amounts an employee may contribute through salary reduction contributions is $3,050 per year.

4412.18 Illness or injury benefits:

a. Benefits received for physical injury and sickness are excluded if received:

(1) under a workers' compensation act,

(2) as compensatory damages from a suit or settlement, or

(3) under self-purchased accident and health insurance.

b. Benefits received under an employer-financed accident and health plan may be exempt from taxation.

(1) Contributions by the employer to accident and health plans for personal injury or sickness are excludible.

(2) Payments received under the plan for medical care and permanent injury are excludible.

(3) Health and accident benefits other than those listed are income to the extent they are attributable to the employer's contribution.

c. A taxpayer who retired on disability must include in income any disability pension received under a plan that is paid for by their employer.

(1) Taxable disability payments are reported as wages until the minimum retirement age is reached. Minimum retirement age generally is the age at which the taxpayer can first receive a pension or annuity if not disabled.

(2) Beginning on the day after the minimum retirement age is reached, payments received are taxable as a pension or annuity.

The taxpayer may be entitled to a tax credit if permanently and totally disabled when they retired.

4412.19 Improvements made by lessee:

a. Generally, the value of improvements made by the lessee is not income to the lessor, and the basis of such improvements to the lessor is $0.

b. If the improvements are made in lieu of rent, improvements are income to the lessor.

(1) The income is recognized in the year improvements are completed.

(2) The market value of the improvements is the amount recognized as income.

(3) The landlord's basis in such improvements is the market value.

4412.20 Income from illegal acts:

a. Income from illegal activities is included in gross income.

b. Cost of goods sold as described per IRC Section 280(E) incurred to produce such income may be deductible as a business expense. This includes producing/selling Schedule I illegal drugs.

4412.21 Interest:

a. Generally, all interest received (or accrued if using the accrual method) or available for withdrawal is taxable.

b. Interest on state and municipal obligations is excluded from gross income.

c. Interest on U.S. savings bonds may be reported in the year accrued or postponed until the year of surrender by a cash-basis taxpayer.

d. Amortization of premiums on taxable bonds is treated as an offset to interest income on bonds acquired after 1987.

e. Imputed interest:

(1) Certain lenders may be required to recognize imputed interest income on loans made below the market rate of interest. That interest rate is referred to as an applicable federal rate (AFR), published by the IRS monthly, and reflects the rate paid by the government on new borrowing. An AFR is stated for demand loans and loans of various terms and maturities.

(2) Imputed interest applies to the following types of below-market loans:

(a) Loans made out of love, affection, or generosity (gift loans)

(b) Loans to employees

(c) Loans to shareholders

(d) Tax avoidance loans

(3) Imputed interest will affect the lender and borrower in the following manner:

(a) The lender must recognize interest income, and the borrower will have interest expense.

(b) The amount of the imputed interest will be considered as a payment from the lender to the borrower. In most situations, this payment will be treated as a gift, as compensation, or as a dividend between the two parties.

(4) Exceptions:

(a) No interest is imputed on gift loans of $10,000 or less between individuals, unless the loan proceeds are used to purchase income-producing property. Employee and shareholder loans of $10,000 or less are also exempt unless tax avoidance is one of the principal purposes of the loan.

(b) Imputed interest cannot exceed the borrower's net investment income on loans of $100,000 or less between individuals.

(c) No interest will be imputed if the borrower's net investment income is $1,000 or less and the loan is not more than $100,000, unless one of the principal purposes of the loan is tax avoidance.

4412.22 Life insurance proceeds:

a. Life insurance proceeds paid by reason of death are not taxed as income (except for a policy received in a transfer for a valuable consideration).

(1) A lump-sum payment of the principal sum is fully excluded from gross income.

(2) The interest portion of any installment payments is taxable.

b. Dividends received on unmatured policies are not taxed unless the amount received exceeds the consideration (premiums) paid.

(1) Dividends received before maturity of the policy are considered as a return of premium.

(2) Dividends collected after maturity of the policy are fully taxable.

c. Qualified individuals may generally "cash out" their life insurance policies before death and receive tax-free treatment for the amount received.

(1) **Qualifications:** The insured person must be terminally or chronically ill.

(2) For chronically ill persons, the exclusion is limited to their unreimbursed long-term care costs paid by the amount received. Terminally ill taxpayers may use the proceeds for any purpose.

(3) Proceeds from the assignment or sale of a life insurance policy will qualify for tax-free recovery of the insured's basis in the policy. "Basis" for this purpose is total premiums paid minus the true cost of insurance.

4412.23 Meals and lodging:

a. If meals are served on the premises of the employer and are for the convenience of the employer, the value of such meals may not be income. The Tax Cuts and Jobs Act of 2017 (TCJA) imposed new rules on this particular fringe benefit and facts such as the availability of other options must be considered. There is no "one size fits all" approach for meals.

b. To exclude lodging from income, lodging on the premises must also be a condition of employment.

c. The rental value of housing provided for a minister is tax exempt as is a housing allowance used to pay for housing.

d. Businesses may deduct up to 50% of business meals.

e. Meals not separately stated from entertainment are generally not deductible. Meals must not be lavish or extravagant and an employee must be present at the meal.

4412.24 Pensions:

a. Pensions paid to retirees are generally taxable.

b. Payments made under the Railroad Retirement Act or the Social Security Act are generally nontaxable.

(1) A portion of the taxpayer's Social Security and Railroad Retirement benefits may be included in gross income.

(2) Basically, the amount includible is the lesser of:

(a) one-half of the benefits received or

(b) one-half of the excess of:

i. AGI (with modifications) plus one-half of the benefits received *over*

ii. the base amount.

a. The base amount is $25,000 for singles, $32,000 for married persons filing jointly, and $0 for married persons filing separately.

b. For this calculation, adjusted gross income (AGI) must be modified to include excludible income earned outside of the United States and tax-exempt interest.

(3) Additionally, when the taxpayer's provisional income (modified AGI plus one-half of the benefits received) exceeds $25,000 but does not exceed $34,000 (singles) or exceeds $32,000 but does not exceed $44,000 (married persons filing jointly), the following rules apply:

If provisional income falls between the ranges above, the amount of the benefits subject to tax is the lesser of:

(a) 50% of the benefits received or

(b) modified AGI in excess of:

i. $25,000 if single.

ii. $32,000 if married, filing jointly.

(4) When the taxpayer's provisional income (modified AGI plus one-half of the benefits received) exceeds $34,000 (singles) or $44,000 (married persons filing jointly), the following rules apply:

(a) If provisional income exceeds $34,000 ($44,000 for married persons filing jointly), the amount of the benefits subject to tax is the lesser of:

i. 85% of the benefits received or

ii. the sum of:

a. 85% of the excess of provisional income over $34,000 ($44,000) plus

b. the lesser of:

1) the amount included under the basic rules listed previously or

2) $4,500 ($6,000 for married persons filing jointly).

(b) Married persons filing separately will include in income the lesser of:

i. 85% of the benefits received or

ii. 85% of the provisional income.

4412.25 Prizes and awards:

a. Prizes and awards are generally taxable.

b. Awards given in recognition of achievement in religious, charitable, scientific, educational, artistic, literary, or civic areas are generally taxable. These types of awards may be excluded from gross income if:

(1) the taxpayer is selected through no action on the taxpayer's part,

(2) the taxpayer need not perform any substantial future services for the award, and

(3) the award is transferred to a government unit or charitable organization before the taxpayer receives any benefit from it.

c. Awards given in recognition of safety achievement or length of service are not taxable if the award is tangible personal property valued at not more than $1,600 for all such awards received during the year ($400 for awards that are not qualified plan awards).

d. The Tax Cuts and Jobs Act of 2017 (TCJA) clarifies that the term "tangible personal property" does **not** include:

(1) cash, cash equivalents, gift cards, gift coupons, or gift certificates (other than those allowing the recipient to select an item of tangible personal property from a limited list preselected by the employer), *or*

(2) vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and similar items.

4412.26 Rents and royalties:

a. Royalties are included in gross income when received.

b. Rental income is any payment received for the use or occupation of property. A taxpayer must include in gross income all amounts that are received as rent.

(1) Rent is taxable when received if the taxpayer uses the cash basis; when accrued, if the taxpayer uses the accrual basis. Any amount received from a tenant to cancel a lease is treated as rent and included in income.

(2) If a tenant pays any of the taxpayer's expenses, the payments are rental income and included in income.

(3) Prepaid rental income (i.e., advance rent) is recognized in the year received whether the taxpayer is on the accrual or cash basis.

c. Security deposits are not included in rental income if the amount is to be returned to the tenant at the end of the lease. If the taxpayer keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, the amount retained becomes income for that year.

d. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent, and as such, it is included as rental income in the year that it is received.

e. Rental of personal residence:

(1) When a personal residence is rented out for less than 15 days, no rental income is recognized and expenses are not required to be prorated between personal use and rental use.

(2) When a personal residence is rented out for more than 14 days, the rental income is recognized and the expenses must be allocated between personal use and rental use. A portion of mortgage interest and real estate taxes must be allocated to reduce the rental income. Taxpayers cannot deduct a loss from renting a personal residence.

4412.27 Recoveries (tax benefit rule):

a. If an income tax benefit was obtained by deducting an item on a previous tax return, any amount recovered must be included in current gross income.

b. If no tax benefit was received in prior years as a result of the item, no income is recognized on current recoveries.

4412.28 Scholarships and fellowships:

a. A degree candidate may exclude scholarships and fellowships to the extent the amount received is used for tuition, course fees, books, and supplies. Amounts used for room and board are taxable.

b. Amounts received are taxable if specific services, such as teaching, are required to receive the scholarship or fellowship.

c. Any amount paid to a nondegree candidate is taxable.

4412.29 Educational assistance:

a. Amounts paid by the employer for educational expenses (tuition, fees, books, and supplies) are excludible from gross income. The CARES (Coronavirus Aid, Relief, and Economic Security) Act expanded eligible educational expenses to include student loan repayments made after March 27, 2020, and before January 1, 2025 (extended by the Consolidated Appropriations Act, 2021 (CAA)). The annual exclusion is limited to $5,250.

b. The exclusion applies to both undergraduate- and graduate-level courses.

4412.30 Stock options:

a. An employee receiving a qualified incentive stock option will not recognize income when it is granted.

b. A sale of the stock will produce long-term capital gain if the sale occurs more than one year after exercise and two years after grant.

c. However, when computing the alternative minimum tax, the taxpayer generally must include the excess of the fair market value of the incentive stock options exercised during the year over the option price.

d. A nonqualified stock option plan requires employee recognition of the bargain element on the exercise date. The bargain element is the difference between the strike price and the fair market value on the exercise date.

4412.31 Stock rights:

a. Generally, the distribution of stock rights does not constitute income. Exceptions include the following:

(1) The option to receive cash or other property in lieu of money

(2) A distribution of stock rights made on preferred stock

b. Nontaxable stock rights:

(1) No income is recognized when rights are received.

(2) The basis of the rights received is generally $0.

(a) The taxpayer may elect to allocate a portion of the basis of the underlying stock to the rights according to the relative fair market values of each at the time of distribution.

(b) If the fair market value of the rights at the date of distribution is 15% or more of the fair market value of the stock on which they are issued, the basis of the stock *must* be allocated between the stock and the rights according to the relative fair market values of each.

(3) The holding period for stock acquired through the exercise of the rights begins at the date of exercise.

c. Taxable stock rights:

(1) Gross income is realized to the extent of the fair market value of the rights at the time of distribution.

(2) The basis of the rights received is equal to the fair market value of the rights.

(3) The holding period for stock acquired through exercise of the rights begins at the date of exercise.

d. The basis of the stock acquired through the exercise of the rights is equal to the subscription price plus the basis of the rights.

4412.32 Unemployment compensation:

a. All unemployment compensation benefits are includible in income.

b. Company-financed supplemental benefits are taxed.

c. Guaranteed annual wage payments are taxed.

4412.33 Foreign income exclusion:

a. Certain taxpayers may elect to exclude foreign earned income of up to a maximum of $120,000 per year for 2023. The exclusion must be calculated on a daily (per diem) basis.

b. Taxpayers may also elect to exclude those housing costs incurred that exceed 16% of the foreign earned income exclusion amount. The amount of housing costs excluded is also subject to a maximum of 30% of the foreign earned income exclusion amount. The amount of housing costs excluded reduces the foreign earned income exclusion available. The foreign earned income and housing cost exclusions may be elected separately or together.

c. To qualify for these exclusions, the taxpayer must be a bona fide resident of a foreign country for an entire taxable year *or* must be physically present in a foreign country for 330 full days out of 12 consecutive months.

d. These two exclusions are subject to limitations and required calculations that can only be accomplished using IRS Form 2555 (*Foreign Earned Income*), which will be attached to the individual's IRS Form 1040.

4412.34 Income in respect of a decedent:

a. Only amounts properly includible as income at the time of death under the decedent's method of accounting are included as income on the decedent's final tax returns.

b. Income in respect of a decedent is income the decedent had a right to receive at the time of death that was not included on the final income tax return filed by the estate.

The value of any amount of such income is included in the decedent's estate, and in the income tax return, of any person who receives it as a result of the decedent's death.

c. Without a taxable estate, over $12.92 million in value under current law (for 2023, as indexed for inflation), there can be no income in respect of a decedent.

d. For those receiving assets from a decedent, the donee receives a fair market value basis in the asset. If the donee subsequently sells the asset, then the gain is calculated as amount realized (everything received of value less any selling costs) less tax basis, where tax basis is the fair market value on the decedent's date of death (or the alternate valuation date if used). The gain (if any) must be included in the taxpayer's gross income. The gain is considered long-term regardless of how long the asset was actually held by the donee.

4412.35 Educational savings bonds:

a. Interest on Series EE and Series I U.S. savings bonds may be excluded from gross income if the redemption proceeds are used for qualified higher education expenses.

b. Requirements include the following:

(1) The bonds must be issued after December 31, 1989.

(2) The bonds must be issued to a person at least 24 years old.

(3) A joint return is required, if married.

c. Qualified higher education expenses mean tuition and fees required to enroll the taxpayer, spouse, or dependent in an eligible educational institution. These expenses do not include room and board. Under the PATH Act of 2015, qualified expenses do include computer equipment and related expenses, such as internet access.

d. Qualified expenses must be reduced by scholarships and similar benefits not included in gross income.

e. When the redemption proceeds (including interest) exceed the education expenses, only a portion of the interest is excluded from income:

$$\frac{\text{Education expenses}}{\text{Redemption proceeds (including interest)}} \times \text{Interest} = \text{Interest exclusion}$$

4412.36 Adoption assistance programs:

a. Qualified adoption expenses paid or incurred by an employer for an employee's adoption of a child are excluded from the employee's income.

b. Payments must be pursuant to a written, nondiscriminatory adoption assistance program.

c. For tax year 2023, the amount that can be excluded is $15,950. The exclusion begins to phase out for MAGI in excess of $239,230 and is completely phased out with MAGI of $279,230 or more.

4412.37 Coverdell Education Savings Account:

a. Distributions from a Coverdell Education Savings Account are excluded from the income of the student (beneficiary of the account) if the funds are used to pay qualified education expenses.

(1) The student must be under age 30.

(2) Qualified expenses include the following postsecondary education expenses: tuition, fees, books, supplies, equipment, and room and board. For room and board to qualify, the student must attend school on at least a half-time basis in a program leading to a recognized education credential.

(3) Qualified expenses also include elementary and secondary school tuition and expenses. Tuition to both public and private schools qualifies.

(4) The Hope and Lifetime Learning tax credits may be claimed in the same year as a distribution from a Coverdell Education Savings Account as long as the proceeds from the distribution are not used for qualified expenditures toward these education credits.

b. When distributions exceed qualified educational expenses, some of the distributed earnings are taxed and some are excluded from income.

(1)

$$\frac{\text{Qualified educational expenses}}{\text{Total distributions}} \times \text{Earnings} \quad = \text{Excluded earnings}$$

(2) Earnings – Excluded earnings = Taxable earnings

(3) Distributions are treated as a pro rata distribution of contributions and earnings. Thus, if 25% of the account balance is earnings, 25% of the distribution is earnings.

c. Setting up a Coverdell Education Savings Account:

(1) Taxpayers may contribute up to $2,000 per child (beneficiary) per year to a Coverdell Education Savings Account. The amount is nondeductible.

(2) Contributions must be for a child of the taxpayer or any other child under the age of 18.

(3) Contribution limits:

(a) The annual $2,000 contribution limit is phased out proportionately between the following AGI levels in 2023:

i. Singles: $95,000–$110,000

ii. Joint filers: $190,000–$220,000

iii. Corporations and other entities making contributions to Coverdell Education Savings Accounts are not subject to the phase-out rules.

(b) The maximum annual contribution to anyone's Coverdell account is $2,000.

(c) The deadline for making contributions is April 15 of the following year.

d. Unused balance:

(1) When the beneficiary reaches age 30, any unused amount in the savings account must be distributed to the beneficiary, unless the beneficiary has special needs.

(2) Any earnings included in the distribution will be added to the beneficiary's gross income and taxed.

(3) An additional 10% penalty tax on the earnings will also apply to the beneficiary.

(4) Unused amounts may be rolled over tax- and penalty-free into a Coverdell Education Savings Account of a child or a sibling or spouse of the beneficiary (if the person is under age 30).

4412.38 Parking and transportation provided by employer:

a. In 2023, up to $300 per month can be excluded for a "qualified parking fringe benefit": parking provided by the employer near the workplace.

(1) Employees can have a choice between cash and employer-provided parking.

(2) If cash is selected, it is included in gross income.

b. The qualified transportation fringe benefit allows an exclusion for combined commuter highway vehicle transportation and transit passes of $300 per month in 2023.

c. No deduction is allowed for any employer expense incurred for providing any transportation, or any payment or reimbursement for transportation fringe benefits, except as necessary to ensure the safety of the employee.

4412.39 Qualified state tuition programs:

a. Some states and private institutions make it possible for parents to prepay their children's college tuition and lock in current tuition rates.

b. If the child does not go to college, the payments, plus interest, are refunded to the parents. The interest is included in the parent's gross income.

c. When the accumulated funds are used to pay qualified higher education expenses, the entire distribution, including earnings, is tax-free.

d. Qualified higher education costs include tuition, fees, books, supplies, room and board, and equipment needed to complete course requirements.

4412.40 Section 1202 small business stock:

a. Noncorporate taxpayers may exclude 50% (100% on stock acquired after the enactment of the Creating Small Business Jobs Act of 2010) of the gain on the sale or exchange of qualified small business stock held for more than five years.

(1) Eligible gain cannot exceed the greater of $10 million or 10 times the taxpayer's basis in the stock ($5 million for married individuals filing separately).

(2) The stock must be C corporation stock acquired as original issue stock.

(3) Corporate assets cannot exceed $50 million at the date of issuance.

(4) At least 80% of the assets must be used in the active conduct of a trade or business.

(5) Service-based corporations do not qualify (e.g., law, insurance, engineering, architecture).

b. Any gain not excluded under this provision is capital gain taxed at the maximum rate of 20%.

4412.41 Section 1244 stock:

a. Generally, the disposition of stock produces capital gain or loss. However, a loss (from sale or worthlessness) on *qualified small business stock* (Section 1244 stock) may be treated as an ordinary loss—deductible for AGI.

(1) Ordinary loss treatment is limited to $50,000 ($100,000 on a joint return) each year.

(2) Any additional loss receives capital loss treatment.

b. Only individuals may receive this treatment and, in order to be *qualified small business stock:*

(1) the stock must have been acquired as original issue from a small domestic corporation.

(2) at the time the stock is issued, contributions of paid-in capital cannot exceed $1 million.

(3) the stock may be common or preferred stock.

c. If Section 1244 stock is sold at a gain, the gain is capital gain.

(1) Individuals may elect to roll over (postpone) the gain by reinvesting in other Section 1244 stock within 60 days after the sale. (IRC Section 1045)

(2) To qualify for the rollover treatment, the stock must have been held for over six months before it was sold.

(3) Gain is recognized to the extent the sale proceeds are not reinvested within 60 days.

4412.42 Employee contributions to retirement plans:

a. Employees who participate in their company's retirement plan may exclude (defer) from the current year's income amounts they contribute to the plan within the following guidelines.

(1) For 2023, participants in 401(k) plans, 403(b) annuities, and SEP programs may elect to contribute and defer taxes on a maximum of $22,500. Taxpayers age 50 and above may make an additional "catch-up" contribution of $7,500.

(2) Employees participating in a SIMPLE plan in 2023 may contribute and defer taxes on $15,500. Taxpayers age 50 and above may make an additional "catch-up" contribution of $3,500 for 2023.

b. Employee contributions and their subsequent earnings are taxed when withdrawn from the plan.

c. Qualified employer contributions to the program and related earnings are also taxed when withdrawn from the plan.

4412.43 Employee business expenses reimbursed by employer:

There are two types of employee business expense plans**:**

1. An accountable plan: The employer has a written policy establishing an "accountable plan" and the employee must provide substantiation for any expense to be reimbursed.

a. If the reimbursement equals the business expense, the employee excludes reimbursement from income.

b. If the reimbursement exceeds the expense, the excess is included in gross income.

2. A nonaccountable plan: The employee does not provide substantiation for the expenses to the employer. The employee includes reimbursements in income. The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated any deduction in an employee's Form 1040 for "unreimbursed business expenses."

4412.44 Gains from the sale of investments or virtual currencies:

a. Gains from the sale of investments including virtual currencies held as investments are classified as long-term or short-term capital gains based on whether the investments are held for over one year or for one year or less.

b. To calculate the gain, subtract the asset's tax basis from the amount realized. The amount realized is all property received of value less any selling expenses.

c. The gain is included in gross income.

4413 Accounting Periods and Methods

Note: The material in this section applies to individuals engaged in a trade or business as self-employed persons or conducting an activity for the production of income. The results of those undertakings are reported in the individual's annual federal income tax return along with other items of personal income.

4413.01 Accounting periods

a. Individuals subject to United States income tax law are generally not permitted to use a fiscal year (a 12-month period ending on the last day of a month other than December) for calculating and reporting their taxable income. Exceptions are possible, but rare. IRC Section 441 and Treasury Regulation 1.441-1(b) explain what would be required.

b. Taxpayers who established a fiscal year before becoming subject to U.S. tax law, and who keep adequate books and records, are generally permitted to use a fiscal tax year. If adequate books and records are not kept, the taxpayer generally must use a calendar tax year.

c. Certain taxpayers may elect to use a 52/53-week tax year.

(1) In this case, the tax accounting period includes either 52 or 53 weeks.

(2) Under this method, the taxpayer's tax year ends on the same day of the week (e.g., the last Sunday in December) each year.

d. A taxpayer makes the election to use a calendar, 52/53-week, or fiscal year at the time of filing their initial tax return.

e. For all subsequent tax years, the taxpayer is required to use the tax year initially selected unless he or she obtains IRS approval to change their tax year.

f. The request to change the taxpayer's tax year must be filed on IRS Form 1128 (*Application to Adopt, Change, or Retain a Tax Year*).

g. The IRS generally will not grant permission to change the taxpayer's accounting period unless there is a substantial nontax business reason for the change.

h. If the IRS allows the taxpayer to change their accounting period, the taxpayer must comply with all conditions set out by the IRS.

Accounting Methods

4413.02 Recognition of revenues and expenses

a. Internal Revenue Code (IRC) Section 446 states that taxpayers must compute their taxable income using the accounting method regularly used to keep their books and records.

b. If the method of accounting used by the taxpayer does not clearly reflect income, the Internal Revenue Service (IRS) can specify the accounting method that the taxpayer must use so that income is "clearly reflected."

c. Taxpayers may compute their taxable income under any of the following methods of accounting:

(1) The cash receipts and disbursements methods

(2) The accrual method

(3) Any other method permitted by the IRC (i.e., the installment method)

(4) Any combination of permissible methods

d. A taxpayer who is engaged in more than one trade or business can use a different method of accounting for each trade or business.

e. The accrual method must generally be used for sales and cost of goods sold if inventories are an income-producing factor in the taxpayer's business, and the taxpayer's average annual gross receipts equal or exceed $29 million (for 2023, as indexed for inflation).

f. Generally, a taxpayer must get IRS consent in order to change a method of accounting. To promote efficiency, the IRS issues Revenue Procedures explaining the automatic consent procedures for accounting method changes. Currently that guidance is contained in Revenue Procedure 2019-43, which incorporates changes required by the Tax Cuts and Jobs Act of 2017 (TCJA) in Revenue Procedure 2018-40.

4413.03 Cash method

a. Under the cash method, a taxpayer generally reports income when consideration is received. Consideration can be cash, a cash equivalent (a check), or property or services (e.g., fair market value of the property or services received in a barter transaction).

b. A taxpayer using the cash method is required to report income if it is constructively received. For constructive receipt to exist:

(1) the amount must be made available to the taxpayer and

(2) receipt of consideration by the taxpayer is not subject to any substantial limitations or restrictions.

c. The constructive receipt doctrine prevents cash-method taxpayers from avoiding income by refusing to accept payment hoping to defer recognition to a future tax year.

d. Cash-method taxpayers deduct expenses in the year paid.

e. However, if a cash-method taxpayer prepays expenses that cover a period substantially beyond the end of the tax year, such amounts must be capitalized and amortized over the period to which they relate.

f. Taxpayers, though, may deduct prepaid expenses in some circumstances if the period covered by the prepaid expenses expires before the end of the tax year following the year of payment, or:

(1) the item is recurring in nature and treated consistently,

(2) accrual results in better reflection of income,

(3) the "all-events test" is met, and

(4) "economic performance" occurs within a reasonable period, but no later than 8.5 months after the end of the tax year.

In any event, the deduction must not distort income. Clear reflection of income trumps any other provision.

g. The one-year rule does not apply to the deduction of prepaid interest. Prepaid interest expense can only be deducted over the period to which the interest relates.

4413.04 Accrual method

a. Under the accrual method, a taxpayer includes an item in income when:

(1) all events have occurred that create the taxpayer's right to receive the income (generally, the goods or services have been provided to the other party) and

(2) the amount of income to be received can be determined with reasonable certainty.

b. An accrual method taxpayer can generally deduct an expense only when:

(1) all events have occurred that establish the taxpayer's liability,

(2) the amount of the liability can be determined with reasonable accuracy, and

(3) the taxpayer has received economic performance from the other party.

c. Economic performance occurs when the services or receipt of property that give rise to the taxpayer's liability are actually received by the taxpayer.

d. An exception to the economic performance requirement allows deduction of recurring items before economic performance, provided:

(1) the item is recurring in nature and is treated consistently from year to year by the taxpayer,

(2) the item accrued is either not material or accruing before economic performance results in a better matching of income and expenses, and

(3) economic performance is received within a reasonable time that is no later than 8-1/2 months after the close of the tax year.

Under this exception to economic performance, all events must still have occurred to establish the taxpayer's liability and the amount of the liability must be known with reasonable certainty.

4413.05 Hybrid method

a. The taxpayer may use a hybrid method that combines more than one method, provided the use of the hybrid method clearly reflects income.

b. The most common example of a hybrid method is use of the accrual method for sales and cost of goods sold while using the cash method to report other income and expenses.

4413.06 Restriction on use of the cash method

a. For tax years beginning after December 31, 2018, taxpayers that have average annual gross receipts of $29 million or less (for 2023, as indexed for inflation; up from $10 million under pre-TCJA (Tax Cuts and Jobs Act of 2017) law) during the preceding three years are not required to account for inventories and related costs of goods sold; therefore, they are not required to use the accrual method of accounting. Such taxpayers will use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies or (2) conforms to the taxpayer's financial accounting treatment of inventories.

b. Prior to the TCJA, uniform capitalization (UNICAP) rules for the capitalization of certain costs applied to many taxpayers, with few exceptions. Under the TCJA, the exception is expanded to apply to taxpayers whose average annual gross receipts for the immediately preceding three years do not exceed $29 million (for 2023, as indexed for inflation; up from $10 million under pre-TCJA law). This increased threshold applies to both producers and resellers of real and personal property, rather than only resellers (as under pre-TCJA law).

c. Under the TCJA, in tax years beginning after December 31, 2017, corporations and partnerships that have a corporation as a partner satisfy the gross receipts test for the tax year if the taxpayer's average annual gross receipts are under $29 million for the three-tax-year period ending with the tax year that precedes the tax year for which the taxpayer is being tested. The $29 million limit is adjusted for inflation for tax years beginning after 2018.

d. Under the TCJA, a farming business owned by a C corporation (or a partnership with such a C corporation as a partner) is exempt from the rule requiring such corporations to use the accrual method if the corporation meets an inflation-adjusted $29 million gross receipts test for the tax year. This limit replaces both the non-inflation-adjusted $25 million limit for family corporations and the $1 million limit for nonfamily corporations in effect before the TCJA.

4414 Capital Gains

4414.01 Capital gains and losses result from the sale of capital assets. Capital assets sold or disposed of after being held for over 1 year result in long-term capital gains or losses. Capital assets sold or disposed of after being held for 1 year or less result in short-term capital gains or losses.

a. Capital losses may be offset capital gains, and any resulting net capital gain must be included in gross income.

b. Generally, virtual currencies held as an investment are treated as capital assets for purposes of calculating capital gain and loss upon disposition.

c. Assets received as a gift and later disposed of generally have capital gain or loss treatment. Assets received as a gift generally receive a carryover basis from the donor and a carryover holding period for purposes of calculating whether the gain or loss is long or short term.

An exception exists for assets where the adjusted basis is greater than fair market value (FMV) at the time of the gift. In this case, if the asset is ultimately sold for an amount in excess of the adjusted basis at the time of the gift, then the donee should use the adjusted basis as the basis with a carryover holding period. If the asset is later sold for an amount less than FMV on the date of the gift, then the donee should use the FMV on the date of the gift as the adjusted basis, and the holding period begins on the day after the date of the gift.

4420 Reporting of Items from Pass-Through Entities

4420.01 Domestic corporations that meet certain eligibility tests may request to be considered pass-through entities. If a qualifying corporation makes an “S election,” income is passed through to the stockholders, who are taxed on their share of the corporation’s earnings. Stockholders are taxed on their share of the earnings even though the earnings are not distributed. (For a detailed discussion of S corporation tax attributes, see section **4530.**)

4420.02 Shareholders must include on their personal tax returns their share of the S corporation’s income or loss and special items from the corporate tax year that has ended with or within the shareholder's tax year. Thus, income is reported and recognized on a basis similar to, but not the same as, that of partnerships.

a. When ownership has changed during the year, each owner must recognize their share of income on a per-share per-day of ownership allocation.

b. Loss pass-throughs in excess of the taxpayer's basis in the corporation may be carried forward indefinitely and deducted when the taxpayer's basis is increased sufficiently, either by the corporation's income or a contribution of capital, to absorb the loss.

4420.03 Distributions of cash and property are basically given the same treatment. Shareholders must recognize, as a distribution, the amount of cash and the fair market value of any property distributed.

a. The taxability of a distribution is determined by its source.

b. Distributions from an S corporation come from the following sources in the order listed:

(1) Distributions are first considered to come from an "accumulated adjustments account" (AAA).

(a) The AAA represents income earned after 1982 adjusted by any additions and subtractions that shareholders were required to make to the basis of their stock for this period. However, no adjustment is made for the following:

i. Tax-exempt income

ii. Corporate expenses not deductible in computing taxable income and not chargeable to a capital account

(b) Distributions from the AAA are nontaxable.

(2) Distributions are then considered as dividends to the extent of any accumulated earnings and profits (E&P) from a time when the corporation's S election was not in effect.

(3) When E&P is exhausted, distributions are a return of capital to the extent of the shareholder's stock basis, and then capital gain.

c. If an S corporation distributes appreciated property to a shareholder, the transfer is treated as if the property had been sold to the shareholder at fair market value.

(1) A gain is recognized at the corporate level.

(2) The gain is subsequently reported to all shareholders, each of whom reports the percentage of the gain equal to her or his percentage ownership of the corporation's shares.

4420.04 Before 2018, partnerships were **not** taxable entities. They were reporting entities. Partnerships functioned as a conduit for income tax purposes and passed all items of income, deduction, gain, loss, and credits through to the partners.

a. Ordinary income and losses along with special gain and loss items flow through the partnership to the partners, who report these items on their tax returns. In addition to individuals, partners can be corporations, trusts, other partnerships, and estates.

b. The partnership must report each partner's distributive share of the ordinary gain or loss as well as any specially treated items that might affect a partner's taxable income as determined by other factors in that partner's individual return.

c. Self-employment taxes apply to all ordinary income, from the conduct of a trade or business, passing to general partners.

d. Beginning with tax year 2018, new rules for auditing partnerships and assessing tax deficiencies will apply. The new rules are commonly referred to as the "partnership audit regime" and they provide, among other items:

(1) a requirement that a partnership appoint a "partnership representative" who will act for the partnership in all matters involving the IRS.

(2) that a tax deficiency arising from an audit of a partnership is a liability of the partnership, not the partners.

(3) elections to deal with issues created by the new rules, such as assessing and collecting a partner's share of a tax deficiency.

(4) generally, partnerships can no longer file amended returns and instead must file administrative adjustment requests (AARs).

(5) a procedure for a small partnership to elect out and remain covered by the TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) rules.

4420.05 IRC Section 199A

a. The Tax Cuts and Jobs Act of 2017 (TCJA) repealed a section of the Internal Revenue Code, Section 199, that was intended to encourage domestic production by offering a deduction of up to nine percentage points in the tax rate paid by domestic producers. Any enterprise that manufactured, created, grew, or extracted to create value benefited from the domestic production activity deduction, or DPAD.

b. A tax incentive for production activities (activities that create wealth) is offered in new IRC Section 199A, and it is called the qualified business income amount, or QBIA. The QBIA offers taxpayers other than corporations a deduction of 20% of qualified business income (QBI), subject to certain limitations.

c. Some commentators have called the new tax break for non-incorporated enterprises the "QBID" (qualified business income *deduction*) to emphasize that it is a deduction.

d. Qualified trades and businesses include all trades and businesses except the trade or business of performing services as an employee and "specified service" trades or businesses (e.g., services in law, consulting, accounting, or financial services, or where the business's principal asset is the reputation or skill of one or more owners or employees who are famous enough, for example, to draw a crowd to a public appearance).

e. The deduction is claimed on the individual IRS Form 1040 of a taxpayer with qualifying income from a sole proprietorship, partnership, S corporation, trust, or estate.

f. For tax year 2023, as long as the taxable income is below $182,100 in an individual return, or $364,200 in a joint return, and the qualified business income (QBI) is also below that threshold, the IRC Section 199A QBID will be 20% of the qualified business income.

g. When either taxable income or QBI exceeds those thresholds, one of four limitations in the new law will come into play to reduce or completely eliminate the QBID:

(1) Taxable income limitation: The QBID is limited to 20% of the lesser of taxable income or QBI.

(2) W-2 wage limitation: The QBID might be limited to 50% of W-2 wages.

(3) W-2 wage and qualified property limitation: The QBID might be limited to the sum of 25% of W-2 wages plus 2.5% of the original cost of all qualified property immediately after acquisition (before any cost recovery, bonus depreciation, or IRC Section 179 amount).

(4) Specified service trade or business limitation: If the trade or business producing the income is a personal service business, when QBI and taxable income exceed $220,050 in an individual return, and when they exceed $440,100 in a joint return, there can be no QBID. The three limitations above do not apply.

h. For tax year 2023, the W-2 wage limitation does not apply to taxpayers with taxable income of less than $182,100 for the year ($364,200 for married filing jointly) and is phased in for taxpayers with taxable income above those thresholds. Taxpayers with taxable income below these same thresholds may qualify to claim a qualified business income deduction (QBID) even when the income is generated from a specified service business or trade.

i. Qualified business income (QBI) is the net amount of income, gain, deduction, and loss from the operation of a business, excluding investment income. Certain categories of income, including certain investment-related income, reasonable compensation paid to the taxpayer for services to the trade or business, and guaranteed payments are excluded from QBI.

j. The calculation, with phase-in, phase-out, and various limitations can get complicated. It is sufficient to know the tax law includes an incentive for individual taxpayers who own an interest in a business whose income is reported in their returns, in the form of a 20% deduction, leaving the individual to pay regular income tax on only the 80% remainder.

k. If the net amount of QBI is less than zero, such amount is treated as a loss from a qualified trade or business in the succeeding taxable year; in other words, the taxpayer's net loss generated in year 1 is carried forward and reduces the subsequent year's IRC Section 199A deduction.

4430 Adjustments and Deductions to Arrive at Adjusted Gross Income and Taxable Income

4430.01 In computing the tax of individuals, special attention must be given to three different income concepts: gross income, adjusted gross income, and taxable income.

4430.02 **Gross income** includes all income from whatever source derived minus certain exclusions that are specifically provided for by law.

a. It is the gross income figure that is used to determine whether or not a person must file a tax return.

b. Gross income is also one of the standards used to determine whether a person may be claimed as the dependent of another taxpayer.

4430.03 **Adjusted gross income** (AGI) is determined by subtracting certain expenses and other deductions allowed by the Internal Revenue Code from gross income.

a. Deductible from gross income are the following:

(1) Expenses of producing business income (Schedule C). This includes such items as advertising, insurance, rent on office space, supplies, fees paid to others, repairs to

business property, taxes and licenses, professional education, travel for business, and 50% of business meals (no deduction for entertainment after 2017).

(2) The net capital loss deduction (Schedule D) (limited to $3,000 per year)

(3) Expenses of producing rent and royalty income (Schedule E)

(4) Expenses of producing farm income (Schedule F)

(5) Educator's expenses (K–12 teacher-incurred expenses for courses, books, supplies, and supplementary materials, up to $300)

(6) Certain unreimbursed business expenses for reservists, performing artists, and fee-basis government officials

(7) Contributions to a Health Savings Account (Form 8889)

(8) 50% of self-employment tax (Schedule SE)

(9) Contributions to retirement plans, including IRAs, subject to limitations when the taxpayer is a participant in an employer’s qualified retirement plan (Form 5498)

(10) 100% of self-employed health insurance premiums

(11) Penalty on early withdrawal of savings

(12) Qualified student loan interest up to $2,500. For tax year 2023 the MAGI phaseout limits remain the same as 2022 with the $2,500 maximum deduction beginning to phase out for joint filers with modified adjusted gross income (MAGI) in excess of $145,000 and for single filers with gross income in excess of $70,000. It is completely phased out for MAGI of $175,000 for joint filers and $85,000 for single filers.

b. AGI is used as a standard for limiting the amount recognized for such items as medical expenses, charitable contributions, and the dependent care credit.

c. Taxpayers who own and materially participate in a pass-through business and have sufficient tax basis and at-risk basis may deduct business losses with a maximum loss that can be taken of $270,000 ($540,000 for married filing jointly filers), with any remaining loss carried forward indefinitely.

4430.04 **Taxable income** is adjusted gross income minus the larger of itemized deductions or the standard deduction.

a. Itemized deductions include qualified personal expenditures incurred for such items as the following:

(1) Medical and dental care: The deduction for medical expenses is the amount of unreimbursed qualifying medical expenses paid during the year regardless of when the services were provided. Medical expenses are considered paid when the credit card charge is made regardless of when the credit card is paid. Medical and dental care expenses in excess of 7.5% of AGI are deductible. This provision was made permanent by the Consolidated Appropriations Act, 2021 (CAA).

(2) State and local taxes or state and local general sales tax deduction capped at $10,000 for tax years beginning after December 31, 2017: For those taxpayers who made a charitable contribution after August 27, 2018, in exchange for a state or local tax credit and their charitable contribution must be reduced as a result of receiving a tax credit, they may qualify for a safe harbor that allows them to treat some or all of the disallowed charitable contribution as a payment of state and local taxes.

(3) Mortgage interest expense: The total amount of mortgage debt cannot exceed $750,000. Interest on any remaining debt from the previous $1 million amount is grandfathered in. Mortgage insurance premiums (e.g., private mortgage insurance, or PMI) are treated as qualified residence interest. In certain instances, home equity loan interest is also deductible (IR-2018-32).

(4) Enhanced mortgage reporting requirements for a lender will apply to returns required to be furnished after December 31, 2016. An interest recipient (lender) must file a separate information return for each qualified mortgage for which it receives $600 or more in interest for a calendar year. The return must include:

(a) the name, address, and taxpayer identification number of the individual from whom the interest was received,

(b) the amount of such interest (other than points) received for the calendar year, and

(c) the amount of points on the mortgage received during the calendar year and whether such points were paid directly by the borrower.

(5) Charitable contributions were limited by the Tax Cuts and Jobs Act of 2017 (TCJA) to 60% of the taxpayer's "contribution base." The taxpayer's contribution base is adjusted gross income (AGI) computed without regard to any net operating loss carryback to the tax year. Any excess contribution can be carried forward as a deductible charitable contribution over the next five years.

(6) Investment expenses, including investment interest

(7) Hobby losses (losses from an "activity not engaged in for profit," not a "trade or business" (IRC Section 183)):

(a) The Tax Cuts and Jobs Act of 2017 (TCJA) eliminates the itemized deduction for expenses not related to an activity conducted for profit, so-called "hobby losses." Some expenses, however, are deductible regardless of the activity in which they are incurred. These would include all expenses to which the taxpayer is normally entitled as an itemized deduction, such as interest, taxes, and casualty losses.

(b) An activity may be treated as a business if it meets the following profitability tests:

i. A profit is generated in any three out of five consecutive years.

ii. A profit is generated in any two out of seven consecutive years for breeding, training, showing, or racing horses.

(c) If facts and circumstances can prove an intent to make a profit, the activity may still be considered a business after failing test *(b)i.* However, the burden of proof is on the taxpayer.

(8) The Tax Cuts and Jobs Act of 2017 (TCJA) denies deductibility for dozens of other miscellaneous deductions that have been previously subject to the 2% floor. Some examples of expenses that are no longer deductible are:

(a) unreimbursed employee business expenses,

(b) union dues,

(c) fees for tax preparation, and

(d) dues to professional societies.

b. The standard deduction is an alternative to itemizing deductions. The standard deduction should be claimed when it exceeds total itemized deductions.

(1) The amount of the basic standard deduction for 2023 is projected to be as follows.

	2023
Unmarried	$13,850
Married, filing jointly	27,700
Qualifying widow(er) with dependent child	27,700
Head of household	20,800
Married, filing separately	13,850

(2) The basic standard deduction may be increased by an additional standard deduction for age 65 or over and/or blind. The additional standard deduction for people who have reached age 65 (or who are blind) is $1,500 for each married taxpayer or $1,850 for unmarried taxpayers.

(3) For tax year 2023, the standard deduction for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,250 or (2) the sum of $400 and the individual's earned income.

(4) The following taxpayers are not eligible to use the standard deduction, so they must itemize:

(a) A married taxpayer filing separately when the other spouse itemizes deductions

(b) A nonresident alien

(c) A taxpayer filing for a period of less than 12 months

c. **Exemptions.** Under the Tax Cuts and Jobs Act of 2017 (TCJA), the personal exemption has been repealed as a counterpoise to the increased standard deduction.

4430.05 **The tax table** is used by individuals to find their tax if taxable income is under a certain threshold (for example, $100,000). Taxable income is computed by figuring adjusted gross income (AGI) and subtracting deductions and credits. If taxable income is greater than the threshold, the tax rate schedules must be used to determine tax due.

4430.06 **Tax rate schedules** (IRS Publication 15-T) are available according to the filing status of the taxpayer.

a. There are seven brackets (10%, 12%, 22%, 24%, 32%, 35%, and 37%) applicable to each filing status. To compute the tax, the taxpayer must choose from one of the following schedules, which are ranked in the order of desirability. (The tax table is organized on a similar basis.)

(1) Married (couples) filing joint return and qualifying widow(er) with dependent child ("Married" is considered all couples who are legally married.)

(2) Unmarried head of household

(3) Single individual

(4) Married individual filing separate return

b. Separate rate schedules apply to estates, trusts, and C corporations.

c. Special rates also apply to long-term capital gains and dividends.

(1) The maximum rate is generally 20%.

(2) For tax year 2023, the capital gains tax rate is 0% for individuals with taxable income up to $44,625, 15% for taxable income up to $492,300, and 20% for taxable income over $492,300. For joint returns, the rates are 0% up to taxable income of $89,250, 15% up to $553,850, and 20% at $553,851 and above.

d. **Qualifying widow(er)s with dependent child** (surviving spouse) may use the joint return rate schedule for the two tax years following the year in which the death of the husband or wife occurred if the following conditions are met:

(1) The surviving spouse must be unmarried.

(2) The surviving spouse must maintain a home as the household of a dependent son or daughter for the entire year.

(3) The surviving spouse must have been entitled to file a joint return with the decedent in the deceased's final tax year.

e. **Head of household (HOH)** is available to a taxpayer who meets the following requirements:

(1) Unmarried individual, other than a nonresident alien or one who qualifies as a qualifying widow(er) with dependent child

(2) Maintains his or her home as the principal place of abode for one or more of the persons described as follows:

(a) A "qualifying child"

i. However, a "qualifying child" who is married must meet the dependency tests of a relative.

ii. Other children who do not meet the definition of a "qualifying child" (e.g., a child age 25) must also meet the dependency tests of a relative.

(b) A relative who qualifies as a dependent other than through a multiple support agreement

Exception: Dependent parents need not live with the taxpayer as long as the taxpayer maintains their household.

(3) The taxpayer's household must be a qualified person's abode for "more than half" of the taxable year. To qualify for head of household status, the taxpayer must pay more than half of the cost of keeping up a home for the year. This cost includes expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. It does not include the costs of clothing, education, medical treatment, vacations, life insurance, or transportation.

(4) The Tax Cuts and Jobs Act of 2017 (TCJA) added a new due diligence penalty for tax return preparers filing individual returns claiming head of household (HOH) status. Proposed regulations impose the same due diligence requirement that applies to the earned income credit. IRS Form 8867, *Paid Preparer's Due Diligence Checklist,* is used by the preparer to document attention to statutory requirements for HOH status.

f. A portion of the 2023 tax rate schedule for unmarried individuals follows:

If taxable income is between:	The tax due is:
0–$11,000	10% of taxable income
$11,001–$44,725	$1,100 + 12% of the amount over $11,000
$44,726–$95,375	$5,147 + 22% of the amount over $44,725
$$95,376–$182,100	$16,290 + 24% of the amount over $95,375

4430.07 **Unearned income** of minor children (called the "kiddie tax") will typically be taxed in 2023 at the parents' marginal tax rate. The first $1,250 qualifies for the child's standard exemption. The child may file their own return, or if the child's income is more than $1,350 but less than $2,500, it may be included on the parents' return for 2023 and is taxed at the child's marginal rate. Income over $2,500 is taxed at the parents' marginal rate.

4430.08 **Charitable contributions:**

a. Taxpayers may deduct charitable contributions of money or property made to qualified organizations if they itemize their deductions. Generally, the deduction is capped at 60% of adjusted gross income (AGI), but 20% and 30% limitations apply in some cases. The deduction for the fair market value of capital gain property is limited to 30% of AGI for the year.

b. Deductions may be made to, or for the use of, organizations that otherwise are qualified under Section 501(c)(3) of the Internal Revenue Code (IRC). These organizations include a community chest, corporation, trust, fund, or foundation organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to animals or children.

c. Contributions must be paid in cash or other property before the close of the taxpayer's tax year to be deductible.

d. Donations other than cash to a qualified organization can generally be deducted at the fair market value of the property. If the property has appreciated in value, however, some adjustments may need to be made.

e. In general, contributions to charitable organizations may be deducted up to 60% of AGI. Contributions to certain private foundations, veterans' organizations, fraternal societies, and cemetery organizations are limited to 30% of AGI.

(1) The 60% limitation applies to (1) all public charities, (2) all private operating foundations, (3) certain private foundations that distribute the contributions they receive to public charities and private operating foundations within 2-1/2 months following the year of receipt, and (4) certain private foundations the contributions to which are pooled in a common fund and the income and corpus of which are paid to public charities.

(2) The 30% limitation applies to private foundations, other than those previously mentioned that qualify for a 60% limitation, and to other organizations described in IRC Section 170(c) that do not qualify for the 60% limitation, such as domestic fraternal societies.

(3) A special limitation applies to certain gifts of long-term capital gain property.

(4) Deductions can be carried forward from any year in which the deduction limit is surpassed, up to a maximum of 5 years.

f. Taxpayers must retain proper documentation of their contributions.

(1) For cash donations, the IRS will only accept one of the following to substantiate a monetary gift: a canceled check, credit card statement, bank statement, or written acknowledgment from the charity.

(2) For donations in excess of $250, the taxpayer must retain a receipt from the charity that includes the following: the charity's name, the value of the gift, the date the donation was made, and a statement verifying that the taxpayer did not receive any goods or services in return for the gift.

(3) For donations of appreciated property there are, as values increase, requirements for disclosure and documentation that include proof of value, up to and including a qualified appraisal and the appraiser's sworn statement with the taxpayer's return.

g. An IRA owner who is at least age 70-1/2 in 2023 may make a qualified charitable distribution (QCD). This is a donation up to $100,000 to charitable organizations directly from their IRA, without that donation being counted as taxable income when it is withdrawn from the IRA. To qualify, contributions must come from a traditional IRA or Roth IRA, and they must be made directly to a qualified charitable organization. Additionally, the donor may not receive goods or services in exchange for the donation, and the donor must retain a receipt from each charity to which a donation is made.

4430.09 Net operating losses (NOLs)

a. Beginning with tax year 2021, net operating losses (NOLs) may only be carried forward indefinitely, limited to 80% of taxable income. Carrybacks are not permitted.

b. For taxable years beginning **before** 2021 and after 2017, taxpayers are eligible for an NOL deduction equal to 100% of taxable income and may carry the NOL deduction back for a maximum of 5 years.

NOL Generated in Tax Years	Eligible for Carryback	Eligible for Carryforward	Eligible to Offset % of Taxable Income
Before 12/31/17	2 tax years	20 tax years	100% of taxable income
2018–2020	5 tax years	Indefinite	100% of taxable income
2021 and beyond	Generally no carryback	Indefinite	80% of taxable income

c. Losses from the active conduct of a trade or business are limited to amounts invested by the taxpayer for which the taxpayer is "at risk." There may be other limitations, but no loss is allowable unless the taxpayer invested assets or is unconditionally obligated to pay debts of the trade or business activity.

d. If the taxpayer's taxable income is negative (a loss), no tax is due currently, and a net operating loss carryover may be available. To compute a net operating loss, remember the following:

(1) Capital losses are deductible only to the extent of capital gains.

(2) No net operating loss carryover deduction is allowed.

(3) Personal deductions can be used only to offset nonbusiness income.

(4) Salary is considered as business income.

(5) Contributions to a self-employment retirement plan are not allowed in calculating the loss.

4430.10 Energy-efficient commercial buildings deduction

a. To qualify for the energy-efficient commercial buildings deduction, the qualifying building must increase its efficiency relative to a reference building by at least 25%.

b. The deduction amount under IRC Section 179D ranges from $0.50 to $1.00 per square foot based on energy improvement magnitude. There is also an additional bonus deduction amount that ranges from $2.50 to $5.00 per square foot.

c. Tax-exempt entities can allocate the deduction to another party.

4440 Loss Limitations

Calculation of Gain or Loss

4440.01 The gain or loss on the disposal of property is computed by comparing the value of the assets received with the investment in the property given up.

	Amount realized
–	Adjusted basis
=	Realized gain or loss

4440.02 The amount realized on the disposition of property is equal to the net proceeds received for that property.

	Gross selling price
–	Selling expenses
=	Amount realized

a. The gross selling price includes everything received for the property given up, including the following:

(1) Cash

(2) Fair market value of property and services received

(3) Amount of mortgage of which the taxpayer was relieved on mortgaged property

b. Selling expenses include advertising, legal fees, commissions, and any other costs required to effect the transfer of property.

Tax Treatment of Gains and Losses

4440.03 When a taxpayer has determined that the taxpayer has a gain or a loss to be recognized, the next step is to establish whether it is to be treated as a capital gain or loss or as an ordinary income or loss item.

4440.04 All items receiving capital gain or loss treatment should be classified as short term or long term.

4440.05 **Loss limitation rules applicable to individuals (IRC Section 461(l)):** For taxable years beginning after December 31, 2017, and before January 1, 2029, the Tax Cuts and Jobs Act of 2017 (TCJA) (and extended by the Inflation Reduction Act (IRA) of 2022) provides that "excess business losses" of a taxpayer other than a corporation are not allowed for the taxable year. A taxpayer's excess business loss is the excess of:

a. the taxpayer's aggregate deductions attributable to his trades or businesses for the year, over:

b. the sum of:

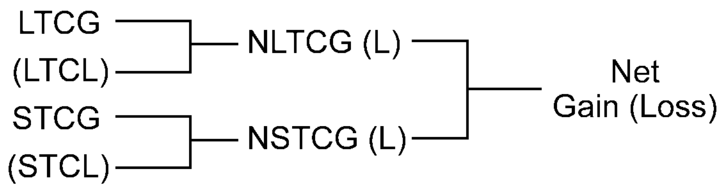
(1) the taxpayer's aggregate gross income or gain for the year attributable to such trades or businesses, plus

(2) $270,000 for a single return (or $540,000 for a joint return)

c. Excess losses are carried forward as net operating losses (NOLs) and allowed in future years, subject to NOL limitations.

d. The loss limitations above apply after any tax basis, at-risk basis, and passive activity loss limitations (if applicable).

4440.06 All items receiving capital gain or loss treatment should be classified as short term or long term and summarized as follows:



The result is either a net capital gain or a net capital loss.

a. Net capital loss carryforwards from prior years into the current year go into the calculation above retaining the same net character.

b. For individuals, if a net capital loss results, up to $3,000 can be used to offset ordinary income in a given year. Any remaining excess net capital loss gets carried forward to next year. These losses can be carried forward indefinitely.

4440.07 Disallowed losses

a. **Hobby losses:** Losses from an activity deemed a hobby as opposed to a business with an intention of making a profit cannot be deducted.

b. **Wash sale:**

(1) A wash sale takes place when securities are sold at a loss and replaced with substantially identical securities within 30 days *before* or *after* the sale.

(2) Such losses are not recognized—they are deferred. The deferred loss increases the basis of the stock or securities acquired.

(3) This law does not apply to dealers.

c. **Personal-use assets:** Losses on the sale, exchange, or condemnation of *personal-use* assets are *not* recognized.

4450 Filing Status

4450.01 There are five filing statuses that might apply to an individual, based on the individual's life circumstance: single, married filing jointly, married filing separately, head of household, and qualifying widow(er). The individual should choose the status, for which they qualify, that results in the lowest tax.

4450.02 Single filing status is for individuals who are unmarried or legally separated on the last day of the year.

4450.03 Married filing jointly filing status is for individuals who are married at the end of the year and both spouses agree to file using the married filing jointly status. If both spouses receive income, they may want to figure the tax using the married filing separately status and married filing jointly status to get the lower combined tax available. If a spouse died during the year, a joint return may be filed. A husband and wife can file a joint return even if the spouses have different accounting methods. If either spouse was a nonresident alien, the couple may file a joint return only if both spouses make an election to file jointly.

4450.04 ***Obergefell v. Hodges*** is a 2015 landmark U.S. Supreme Court decision in which the Court held that the fundamental right to marry is guaranteed to same-sex couples by both the Due Process Clause and the Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution. All states must now issue marriage licenses to same-sex couples and recognize same-sex marriages validly performed in other jurisdictions.

a. Prior to *Obergefell,* many states had issued guidance that required same-sex couples married in other states to file separate state income tax returns, even if their filing status was married filing jointly for federal income tax purposes.

b. Some states required that each individual who has income attributable to their state of residence, and who has filed a joint return with the IRS as a same-sex couple, must separately report adjusted gross income (AGI) for state income tax as a single filer. Each individual had to recalculate their federal AGI as if they had filed a single federal return, essentially requiring the preparation of "dummy" federal returns. As a result of the *Obergefell* decision, those in a same-sex marriage are considered married for state and federal return purposes, eliminating the need for the preparation of "dummy" returns.

c. Also, prior to *Obergefell,* same-sex couples with filing obligations in more than one state might have been required to file as married in one state and as unmarried in another state. *Obergefell* has now alleviated these types of state tax law complexities.

d. Until *Obergefell,* same-sex couples in many states did not benefit from the presumption of parentage for all children born within the marriage; often the non-birth parent had to undertake the expensive and difficult process of adoption. Additionally, since many states prohibit "second parent" adoptions, a parent in a same-sex relationship might not be recognized as a child's parent when the family relocated in another state. *Obergefell* resolves this problem; if states must recognize same-sex marriage, "on the same terms and conditions as opposite-sex couples," then states must recognize parents in such marriages as parents "on the same terms and conditions as opposite-sex couples."

4450.05 Married filing separately status is for individuals who want to be responsible for only their portion of income, or if it results in less tax than filing jointly.

4450.06 Head of household filing status is for individuals who meet the following requirements:

a. The individual is considered unmarried on the last day of the year.

b. The individual paid for more than half the expenses of keeping a home for the year, including rental value of the home, utilities, property taxes, food consumed in the home, homeowner's insurance, repairs, etc.

c. The individual had a "qualifying person" living with them for more than half the year. If the "qualifying person" is a dependent parent, he or she does not have to live with the individual.

4450.07 Qualifying widow(er) (surviving spouse) filing status allows an individual to retain the benefits of the married filing jointly status for two years after the year of the spouse's death. To qualify for the qualifying widow(er) filing status, all five of the following criteria must be met:

1. For the year in which the spouse died, the individual filed (or could have filed) a joint return.

2. The individual did not remarry (during the two years after the year of the spouse's death).
3. The individual has a child or stepchild (not a foster child) whom they are able to claim as a dependent.
4. The child lived with the individual in their home all year, except for temporary absences. There are exceptions for birth, death, or kidnapping.
5. The individual paid more than half the total cost of keeping up the home in which they and the child lived for the year. Costs include food expenses, rent, mortgage interest, home insurance, real estate taxes, utilities, repairs, maintenance, and other household expenses.

Personal Exemptions

4450.08 The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated all personal exemptions until 2025.

4460 Computation of Tax and Credits

Tax Formula for Individuals

4460.01 The following tax formula is for individuals. Each step in the formula must be completed before the succeeding step is considered.

	Total income
–	Exclusions
=	Gross income
–	Deductions from gross income
=	Adjusted gross income
–	Larger of: Itemized deductions or standard deduction
–	Qualified business income deduction
=	Taxable income
×	Tax rate
=	Tax liability before additions and credits
+	Additions to tax
–	Tax credits
=	Final tax due (Refund)

4460.02 An expansion of the tax formula follows. It includes tax topics frequently encountered on the CPA Examination. This outline can be used as a quick review before the examination. However, keep in mind that the items in this expanded tax formula are “topics.” Many of them are subject to specific provisions in the law that provide for exclusion, limitation, or special treatment. These are explained in the material that follows.

Tax Formula – Individuals

Gross Income
(But Not Limited to)

- Alimony received (pre-2018 divorce decree)
- Annuities
- Dividends
  - Stock
  - Cash
  - Property
- Employee benefit programs
- Employer-paid adoption expenses
- Foreign earned income
- Gambling winnings
- Interest
- Gain on sale of residence
- Capital gains
- Rental income
- Unemployment benefits
- Social Security/railroad retirement
- Workers' compensation
- Prizes and awards
- Damages received for physical injury
- Recoveries
- Group-term life insurance
- Scholarships
- W-2 wages

– Deductions from Gross Income

- Alimony payments (pre-2018 divorce decree)
- Business expenses (Schedule C)
- Expenses of producing rent and royalty income (Schedule E)
- Capital loss deduction (Schedule D)
- Contributions to retirement plans (Self-employed SEP, SIMPLE, Keogh IRA, 401(k))
- Student loan interest
- Qualified higher education expenses
- Health Savings Account
- 50% of self-employment tax
- Self-employed health insurance premiums
- Interest forfeited to bank on premature withdrawals
- Certain expenses of Reservists, performing artists, and fee-basis government officials

= Adjusted Gross Income

Adjusted Gross Income **– Greater of:** **Itemized Deductions** **or** **Standard Deductions** **= Taxable Income**	ITEMIZED DEDUCTIONS Medical expenses Taxes (state and local with limit of $10,000) Interest expense Contributions Unrecovered investment in pension Impairment-related work expenses of a handicapped person STANDARD DEDUCTIONS Additions to the standard deduction Age 65 married/single Blindness married/single
Tax Tables **Rate Schedules** **= Tentative Tax**	Married – joint return Qualifying widow(er) with dependent child Head of household Single Married – separate return
+ Additions	Self-employment tax (Schedule SE) Household employment taxes (Schedule H) Alternative minimum tax Net investment income tax Additional Medicare tax
– Credits **= Income Tax**	Foreign tax credit Child/dependent care credit Credit for elderly or disabled American Opportunity Credit (formerly Hope credit) Lifetime Learning Credit Child tax credit Credit for adoption expenses General business credit: Business energy tax credit Credit for research and experimentation payments Investment credit Rehabilitation expenditures credit Low-income housing credit Disabled Access Credit Certain mortgage interest credit Credit for FICA tax on tips Work opportunity credit Child tax credit and family credit Credit for contributions to qualified retirement plans Earned income credit

Tax Credits

4460.03 **Tax credits** reduce the tax liability on a *dollar-for-dollar basis*. While most tax credits are limited to the income tax liability, some credits are further restricted as to the amount of the tax liability that they can offset. The general business credit is an example of such a restricted credit. Additionally, some tax credits are refundable and some are nonrefundable. Refundable credits are those where the taxpayer receives money in exchange for any excess credits that cannot be used. Nonrefundable credits can only reduce tax liability and cannot be refunded in cash if unused.

a. General business credit

(1) Each of the business tax credits is computed separately and then combined to form a single "general business credit." A partial list of these credits follows.

(a) Investment credit

(b) Work opportunity credit

(c) Research activities credit

(d) Low-income housing credit

(e) Disabled access credit

(f) Employer-provided childcare facilities and services credit

(2) The deduction for the general business credit is limited to the lower of:

(a) the excess of the taxpayer's regular tax liability over the tentative minimum tax for the year or

(b) $25,000 plus 75% of the tax liability in excess of $25,000.

(3) Any unused credit may be carried back 1 year and forward 20 years on a first-in, first-out basis.

b. Some tax credits are based on the qualifying dependent rules, including the child tax credit, dependent credit, and earned income tax credit. In addition, the rules help determine if the taxpayer can write off dependent daycare expenses, medical expenses, various itemized deductions, and most tax credits that involve children or family issues.

Qualified dependents are persons who qualify in one of the following three groups:

(1) **Qualifying relative:** A qualifying relative is anyone who meets the following five tests but does not meet the definition of a qualifying child (defined below).

(a) **Gross income test:** The dependent must have less than a stated amount of gross income (e.g., $4,700 for 2023).

(b) **Support test:** The taxpayer must furnish more than half of the support of the dependent. (Exception—multiple support agreements)

(c) **Relationship test:** The dependent must be a closer relative than a cousin, **or** if not related must live in the taxpayer's household for the entire tax year.

(d) **Joint return test:** The dependent must not have filed a joint return in a situation where a tax return was required.

(e) **Citizenship test:** The dependent must be a U.S. citizen or resident of the United States, or a resident of Canada or Mexico.

(2) **Qualifying nonrelative:** A qualifying nonrelative must meet all of the following tests that apply to relatives.

(a) **Gross income test**

(b) **Support test**

(c) **Joint return test**

(d) **Citizenship test**

(e) In addition, an unrelated person must live with the taxpayer for the entire year.

(3) **Qualifying child:** A qualifying child must meet all the following conditions.

(a) **Relationship:** The child must be the taxpayer's son, daughter, stepson, stepdaughter, eligible foster child or descendant of such a child, **or** the taxpayer's brother, sister, stepbrother, stepsister, half-brother, half-sister, or descendants of such relatives.

(b) **Age:** The child must be under the age of 19, or under the age of 24 and a full-time student for at least part of five calendar months.

(c) **Citizenship:** The child must be a citizen or resident of the United States, or a resident of Canada or Mexico.

(d) **Principal residence:** The child must have the same principal residence as the taxpayer for more than half of the year.

(e) **Not self-supporting:** The child must not have provided more than 50% of their own support during the tax year.

(f) **Joint return:** The child must not have filed a joint return in a situation where a tax return was required.

(g) **Note:** A qualifying child is not subject to the "gross income test" and the "over half support test" that apply to qualifying relatives.

4460.04 **Investment credit (ITC):** This general business credit is based on the amount invested in qualified business properties during the tax year. While there are four separate credits currently included in the calculation of the ITC, only the rehabilitation credit will be discussed. The investment credit is claimed by filing IRS Form 3468, *Investment Credit,* with the taxpayer's return.

a. **A rehabilitation credit** will be allowed to taxpayers for expenditures incurred to rehabilitate old commercial and industrial buildings and certified historic structures. No credit is allowed for personal-use property.

b. The credit is 20% of the expenditures incurred to rehabilitate buildings that were placed in service after 1936.

c. The taxpayer is required to depreciate rehabilitated property using the straight-line method.

d. The basis of rehabilitated buildings must be reduced by 100% of the rehabilitation credit taken.

e. The rehabilitation credit is subject to recapture provisions if the building is disposed of prematurely or ceases to be qualified property.

f. The Tax Cuts and Jobs Act (TCJA), signed December 22, 2017, affects the rehabilitation tax credit for amounts that taxpayers pay or incur for qualified expenditures after December 31, 2017. The credit is a percentage of expenditures for the rehabilitation of qualifying buildings in the year the property is placed in service. The legislation:

(1) requires taxpayers take the 20% credit ratably over five years instead of in the year they placed the building into service.

(2) eliminates the 10% rehabilitation credit for pre-1936 buildings.

g. A transition rule provides relief to owners of either a certified historic structure or a pre-1936 building by allowing owners to use the prior law if the project meets these conditions:

(1) The taxpayer owns or leases the building on January 1, 2018, and at all times thereafter.

(2) The 24- or 60-month period selected for the substantial rehabilitation test begins by June 20, 2018.

4460.05 **Work opportunity credit** (a general business credit): Employers hiring employees from 1 of 10 selected high unemployment groups are allowed a special credit. After completing and filing IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit,* the work opportunity credit is claimed by completing and attaching IRS Form 5884, *Work Opportunity Credit,* to the tax return.

a. The credit is equal to 40% of the first $6,000 of first-year wages paid or accrued to each qualified employee who is hired during the year. That first-year wage amount can be as much as $24,000 for certain qualified veterans (service-connected disability).

(1) To qualify for the 40% rate, an employee must complete 400 or more hours of service.

(2) Employees completing less than 400 hours of service, but at least 120 hours, qualify for a rate of only 25%.

b. The work opportunity tax credit is elective. If taken, the employer's deduction for wages must be reduced by the amount of the credit.

4460.06 **Research activities credit** (a general business credit): To encourage technical research and development (R&D), a tax credit is available for qualified R&D expenditures. The credit is based on two research components. The research credit is claimed by completing and attaching IRS Form 6765, *Credit for Increasing Research Activities,* to the tax return.

a. **Amount of credit.** The research credit is the sum of (1) 20% of the excess of qualified research expenses for the current year over a base period amount, (2) 20% of the basic research payments made to a qualified research organization, and (3) 20% of the amounts paid to an energy research consortium.

b. **Base amount.** The base amount is determined by a special formula, but it may not be less than 50% of the qualified research expenses for the current year.

c. The research activities credit must be claimed over 60 months (5 years). However, the deduction for research expenditures must be reduced by the credit taken.

d. Eligible small businesses may use the credit to offset both regular tax and AMT (alternative minimum tax) liabilities, as well as payroll taxes (both Medicare Hospital Insurance and Social Security taxes).

4460.07 **Low-income housing credit** (a general business credit): A tax credit may be claimed by owners of low-income rental housing units constructed, rehabilitated, or acquired after 1986. The credit is claimed by completing and attaching IRS Form 8586, *Low-Income Housing Credit,* to the tax return.

a. A credit may be taken in each of 10 years starting with the year the project is placed in service, or the next year if the taxpayer so elects.

b. The annual credit is equal to:

	Qualified basis of low-income rental units
×	Applicable percentage rate
=	Low-income housing credit

(1) The qualified basis is that portion of the building's qualified cost that is attributable to low-income rental units.

(2) The applicable percentages are issued by the IRS for the month the building is placed in service.

c. An owner is required to recapture part of the credits taken if the owner disposes of the interest in the project or violates some aspect of the original entitlement any time within a 15-year period.

4460.08 **Disabled access credit** (a general business credit): Qualified taxpayers have available a nonrefundable tax credit that is based on expenditures incurred to make their business accessible to disabled individuals. IRS Form 8826, *Disabled Access Credit,* is completed and attached to the taxpayer's return to claim the credit.

a. The credit is equal to 50% of the eligible access expenditures for the year that fall between $250 and $10,250. Thus, the maximum credit available is $5,000 (50% × ($10,250 – $250)).

b. The credit is available to those small businesses that in the preceding tax year had either:

(1) gross receipts of $1 million or less or

(2) 30, or fewer, full-time employees.

c. The credit is not available for expenditures paid or incurred on buildings placed in service after November 5, 1990.

d. The adjusted basis is reduced by the full amount of the credit taken.

4460.09 **Employer-provided childcare credit** (a general business credit): To encourage smaller businesses to provide childcare for their employees, a credit is available for childcare expenses paid by the employer. IRS Form 8882, *Credit for Employer-Provided Childcare Facilities and Services,* is completed and attached to the business tax return to claim the credit.

a. A 25% credit is available for expenditures to acquire or prepare property for use as a childcare facility. The 25% credit also applies to:

(1) the operating costs of a childcare facility or

(2) the amount paid to a contracted childcare facility to provide childcare services to the taxpayer's employees.

b. A 10% credit is also available for expenses paid by the employer under a contract to provide childcare resource and referral services to the employees.

c. The total credit cannot exceed $150,000 per year.

d. Any credit based on the acquisition or improvement of property must be used to reduce the basis of that property. Likewise, any deductible expenses must be reduced by the related tax credit.

e. If a credit is claimed for a property acquisition or improvement, terminating the use of that property as a childcare facility within 10 years will trigger a recapture of some or all of the credit claimed.

4460.10 Credit for the elderly and the permanently and totally disabled: Individuals age 65 or over and individuals under 65 who are permanently and totally disabled have a special tax credit available. This credit is claimed on Schedule R of IRS Form 1040.

a. Individuals are permanently and totally disabled when they are expected to be unable to work for a period of 12 continuous months.

b. This credit is equal to 15% of a base figure after certain adjustments.

(1) The base figure available to the taxpayer depends on the following factors:

(a) **Singles:**

i. Age 65—$5,000

ii. Disabled—lesser of $5,000 or disability income

(b) **Married persons filing jointly:**

i. Both 65—$7,500

ii. One 65—$5,000

iii. One 65, one disabled—lesser of $7,500 or $5,000 plus disability income

iv. One disabled—lesser of $5,000 or disability income

v. Both disabled—lesser of $7,500 or sum of spouses' disability income

(c) **Married persons filing separately:**

i. Age 65—$3,750

ii. Disabled—lesser of $3,750 or disability income

(2) Adjustments (deductions) to the base figure are required for the following:

(a) Social Security payments

(b) Railroad Retirement pensions

(c) One-half of adjusted gross income in excess of:

i. $7,500 (single)

ii. $10,000 (married, filing jointly)

iii. $5,000 (married, filing separately)

c. A married taxpayer filing separately may use the credit only if the couple has lived apart the entire tax year.

4460.11 Foreign tax credit: A taxpayer may apply income taxes paid to a foreign country or U.S. possession as a credit against United States income tax liability or may use such taxes as an itemized deduction. This credit is claimed on IRS Form 1116 for an individual and on IRS Form 1118 for a corporation.

a. This treatment is available for taxes paid to a foreign country on income that is taxable in the United States when no foreign income exclusion is taken.

b. The election to use the credit or the deduction is made annually.

c. The taxpayer cannot split foreign taxes between a credit and a deduction.

d. The overall limit for the credit on taxes paid to *all* foreign countries is restricted to that portion of the U.S. income tax which relates to the taxable income from all foreign countries.

$$\frac{\text{Total foreign taxable income}}{\text{Total worldwide taxable income}} \times \text{U.S. income tax}$$

e. Excess credits may be carried back 1 year and forward 10 years.

4460.12 **Child and dependent care credit:** Taxpayers are permitted a nonrefundable tax credit for expenses incurred in caring for dependents so that the taxpayer(s) may be gainfully employed.

a. The credit is available on a three-tiered basis as follows:

(1) Taxpayers with an adjusted gross income of $15,000 or less will be entitled to a credit of 35% of dependent care expenses.

(2) The credit will be reduced by one percentage point for each $2,000 of adjusted gross income, or fraction thereof, above $15,000.

(3) For taxpayers with an adjusted gross income over $43,000, the credit will be 20%.

b. The maximum amount of dependent care expenses that may be considered for the credit is $3,000 if there is one qualifying child or dependent and $6,000 if there are two or more qualifying dependents.

c. Expenditures for dependent care cannot exceed the earned income of the low-income parent.

Special provisions apply where one of the spouses is a full-time student or is incapacitated, and the other spouse works. In this situation, the nonworking spouse is considered to have earned at least $250 per month, where one dependent requires care and $500 per month, where more than one dependent requires care.

d. The dependent must be:

(1) a child under age 13 or

(2) an incapacitated dependent or spouse.

e. Married taxpayers must file a joint return unless they live apart for the last six months of the year.

(1) For divorced or separated parents, the credit is available to the parent having custody of the child for the longer period.

(2) A custodial parent may claim the credit even though the child may not qualify as a dependent. However, two taxpayers filing separate returns cannot claim separate credits for the same child.

f. Expenditures that qualify for the credit include amounts paid for both in-the-home care and out-of-the-home care.

(1) In-the-home care may include expenditures for household services if they were partly for the well-being and protection of a qualifying individual.

(2) Expenditures for out-of-the-home care are eligible for the credit only if incurred for:

(a) a dependent under age 13 or

(b) any other qualifying person who regularly spends at least eight hours each day in the taxpayer's household.

g. Expenditures do not qualify for the credit if they were made to:

(1) a relative who is a dependent of the taxpayer or

(2) the taxpayer's child who is under age 19.

4460.13 **Credit for mortgage interest paid:** Qualified low-income homeowners who hold a mortgage credit certificate (MCC) may claim a credit for a portion of the interest paid on their home mortgage. This credit is claimed by filing IRS Form 8396, *Mortgage Interest Credit.*

a. This credit must be applied for when the taxpayer is qualified by the lender.

b. MCCs are issued by the state to low-income taxpayers who plan to borrow money to purchase or improve a home.

c. The portion of the mortgage interest that can be used as a credit is determined by the state, but it can range from 10% to 50% of the interest paid.

d. If the percentage exceeds 20%, the taxpayer's maximum credit for the year is $2,000.

e. Credits in excess of the tax liability may be carried over for three years.

f. The taxpayer's itemized deduction for mortgage interest must be reduced by the amount of the credit claimed.

4460.14 **Earned income credit:** A special refundable tax credit may be available for low-income workers who have a principal residence in the United States. It represents a form of *negative income tax*—workers may receive money from the government even though they do not have a tax liability. This credit is claimed by filing Schedule EIC of IRS Form 1040 with the taxpayer's return.

a. The earned income tax credit (EIC or EITC) is equal to a percentage of a limited amount of earned income. Taxpayers with qualifying children receive greater benefits—a greater amount of income is eligible for a higher credit percentage.

b. When the taxpayer's adjusted gross income (or earned income, if greater) exceeds a threshold amount, the EIC is phased out.

(1) "Earned income" includes only taxable compensation; it does not include nontaxable employee compensation.

(2) Threshold and phaseout amounts for 2023 are given in the following table. The tax year 2023 earned income and adjusted gross income (AGI) must each be less than:

	Qualifying Children Claimed			
If filing…	**Zero**	**One**	**Two**	**Three or More**
Single, head of household, or widowed	$17,640	$46,560	$52,918	$56,838
Married filing jointly	24,210	53,120	59,478	63,698

(3) No credit is allowed to those with "disqualified income" (i.e., investment income or unearned income) in excess of $11,000 for 2023 (indexed for inflation).

(4) No credit is allowed for those failing to provide correct Social Security numbers for themselves, spouse, and qualifying child.

(5) The maximum amount of credit for 2023 is $7,430 with three or more qualifying children, $6,604 with two qualifying children, $3,995 with one qualifying child, and $600 with no qualifying children.

c. IRC Section 32(d) provides that a married taxpayer who does not file a joint return is not entitled to an earned income credit (EIC). In Action on Decision (AOD) 2017-05, the IRS gave notice it would not follow a Tax Court decision that the taxpayer's filing status was married filing separately, the taxpayer had qualifying children, and therefore the taxpayer was entitled to the EIC. However, there is no mention of IRC Section 32(d) in the court's opinion; therefore, it appears that the Tax Court overlooked the prohibition disallowing the EIC to married taxpayers filing separately. The IRS has stated it *will not follow* the court's opinion in allowing an EIC to a married taxpayer filing separately.

d. **Qualifying children:** To be eligible for the earned income credit (EIC), parents must have children that can meet the following tests:

(1) **Relationship:** The child must be a "qualifying child." The child may, however, provide over half of his or her own support.

(2) **Residency:** The child must live in the taxpayer's residence over half of the year; foster children for the entire tax year.

(3) **Age:** The child must be:

(a) under age 19,

(b) a full-time student under age 24, or

(c) permanently and totally disabled.

e. Individuals without qualifying children may be eligible for this credit if:

(1) they (or their spouse) are at least 19 years old at the end of the year and not a full-time student (the age limit then increases to 24 years old) and

(2) they cannot be claimed as a dependent by another taxpayer.

4460.15 **FICA tax credit on tips:** Proprietors of food and beverage establishments may claim a tax credit for a portion of the employer's share of FICA taxes. The credit is limited to those FICA taxes attributable to reported tips in excess of those treated as wages under the federal minimum wage laws. No deduction is permitted for any of the FICA expense claimed as a credit. The credit is claimed by filing IRS Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips,* with the business tax return.

4460.16 **Credit for withholding and estimated tax payments:** A refundable tax credit is available to the taxpayer for withheld taxes and estimated tax payments.

4460.17 **Adoption credit:** A nonrefundable tax credit is available for qualified adoption expenses paid or incurred in the adoption of a qualified child. Expenses paid before adoption are claimed as a credit in the year the adoption is finalized. The credit is claimed by completing and filing IRS Form 8839, *Qualified Adoption Expenses,* with the taxpayer's return.

a. **Qualified expenses** include reasonable and necessary adoption fees, court costs, attorney fees, and other directly related expenses. For 2023, expenses up to $15,950 may be claimed as a credit. Adoption expenses for a child with special needs are considered to be $15,950, even if actual expenses are less.

b. **Qualifying children** are those under age 18 or those who are physically or mentally handicapped.

c. The credit allowable is phased out ratably as AGI rises from $239,230 to $279,230.

d. Unused credits carry forward five years.

e. Married taxpayers must file jointly, and the child's Social Security number must be reported.

4460.18 **Child tax credit:** The child tax credit (CTC) under the TCJA (Tax Cuts and Jobs Act of 2017) tax reform is worth up to $2,000 per qualifying child. The age cutoff remains at 17. (The child must be *under* age 17 at the end of the year for taxpayers to claim the credit.)

a. **Child dependent:** For 2023, the refundable portion of the credit is limited to $1,500. The beginning credit phaseout for the CTC in 2023 is $200,000 ($400,000 for joint filers). The child must have a valid Social Security number (SSN) to qualify for the $2,000 CTC.

b. **Other dependents:** This new credit, created under the TCJA, allows for a credit worth $500 for each qualifying dependent who does not qualify for the child tax credit discussed in *(a)* above; the credit is nonrefundable. For 2023, the phaseout begins for taxpayers with AGI of $200,000 ($400,000 for joint filers). This phaseout applies in combination with the new child tax credit. Unlike the child tax credit, the dependent does not require a valid SSN for the taxpayer to claim the credit for other dependents; an ITIN (Individual Taxpayer Identification Number) or ATIN (Adoption Taxpayer Identification Number) will suffice.

4460.19 **Education tax credits:** Two tax credits available for students pursuing postsecondary college or vocational education are the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available for qualified educational expenditures of the taxpayer, spouse, and dependents. If both the Lifetime Learning Credit and the American Opportunity Tax Credit can be claimed for the same student in the same year, only one can be used, not both. Both credits must be supported by an IRS Form 1098-T from the college or other postsecondary institution showing the amount of qualified expenses that were paid during the tax year.

a. **American Opportunity Tax Credit (AOTC):** The AOTC, formerly the Hope Credit, is available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four postsecondary education years instead of two.

(1) The credit is equal to 100% of the first $2,000 and 25% of the next $2,000, not to exceed $4,000. Therefore, the maximum Hope Scholarship Credit allowance is $2,500.

(2) To be eligible for the AOTC, students must:

(a) be enrolled no less than half-time during at least one academic period during the year,

(b) be pursuing a degree or other recognized education credential,

(c) not have completed four years of higher education before the tax year,

(d) not have claimed the AOTC or the former Hope Credit for more than four tax years, and

(e) not have a felony drug conviction at the end of the tax year.

(3) The taxpayer claiming the full credit (not necessarily the student) must have modified adjusted gross income (MAGI) of $80,000 or less for a single taxpayer or $160,000 or less if filing jointly. A partial credit may be available up to MAGI of $90,000 and $180,000, respectively.

(4) A taxpayer can claim the credit for each qualifying student for whom qualifying expenses are paid.

b. Lifetime Learning Credit: This nonrefundable credit is equal to 20% of up to $10,000 of tuition expenses paid each year by the taxpayer. Expenses for which the American Opportunity Tax Credit is claimed do not qualify for this credit. In contrast to the American Opportunity Tax Credit, this credit:

(1) does not vary with the number of students in the household,

(2) is available for an unlimited number of years,

(3) applies to undergraduate, graduate, and professional degree expenses,

(4) applies to any course at an eligible institution that helps individuals acquire or improve their job skills, and

(5) does not require half-time enrollment for one semester. (Thus, CPE credit courses and professional seminars provided by eligible educational institutions may qualify for the credit; but see *(c)(3)* below.)

For tax year 2023, the credit phases out between gross income of $80,000 and $90,000 for single individuals ($160,000 and $180,000 for a joint return) and is used to determine the reduction in the amount of the Lifetime Learning Credit otherwise allowable. The updated phaseout limits have been introduced by the Consolidated Appropriations Act, 2021 (CAA), which passed after the publication of Revenue Procedure 2020-45 (*2021 Adjusted Items*). Under the CAA, the tuition and fees deduction was eliminated and replaced with an expanded Lifetime Learning Credit.

c. Other limitations:

(1) Married taxpayers must file jointly to receive these credits.

(2) In a given tax year, only one of the following benefits may be claimed with respect to each student: (a) the American Opportunity Tax Credit or (b) the Lifetime Learning Credit. However, the American Opportunity Tax or Lifetime Learning credit can be claimed in the same year as distributions from a Coverdell Education IRA, provided that the proceeds from the distribution are not used to pay for the education costs used in claiming the American Opportunity or Lifetime Learning credit.

(3) The credits are not available if the cost of the course may be deducted by the taxpayer as a business expense.

4460.20 **Saver's credit for contributions to qualified retirement plans:** A nonrefundable tax credit is available for contributions, or deferrals, to retirement savings plans. The credit is claimed by completing and attaching IRS Form 8880, *Credit for Qualified Retirement Savings Contributions,* to the taxpayer's return.

a. The credit applies to traditional and Roth IRAs and other qualified retirement plans such as 401(k) plans, 403(b) annuities, 457 plans, SIMPLE plans, and SEP plans.

b. For tax year 2023, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to $2,000 of their qualified retirement savings contributions. In other words, the absolute most the credit could be is $1,000 ($2,000 for married filing jointly).

c. The credit is in addition to any deduction or exclusion relating to the retirement plan contribution.

d. Joint filers with AGI in excess of $73,000 receive no credit. For heads of households, the amount is $54,750, and for all others it is $36,500.

e. The contribution eligible for the credit must be reduced by any distributions received from qualified retirement plans.

(1) Such distributions include those paid out during (a) the current year, (b) the two preceding tax years, and (c) the period before the due date (including extensions) of the current return.

(2) Distributions received by a spouse are considered as distributions to the taxpayer if a joint return is filed.

f. Qualifying taxpayers must be at least 18 years old.

g. Dependents and full-time students are not eligible for the credit.

4460.21 **Premium tax credit (PTC):** The premium tax credit is a refundable credit to help cover the cost of premiums paid for health insurance purchased through the Health Insurance Marketplace.

a. This credit is available for taxpayers making no more than 400% of the federal poverty line (FPL).

b. Additionally, under the American Rescue Plan Act (ARPA) and extended by the Inflation Reduction Act (IRA) of 2022, taxpayers making over 400% of the FPL are still eligible for the PTC if their premiums for health insurance are greater than 8.5% of their household income. This special rule for taxpayers making over 400% of the FPL is in effect through December 31, 2025.

4460.22 **Energy-efficient home improvement credit:** This is a credit for eligible home improvements made during the current year.

a. The credit went into effect January 1, 2023.

b. The credit rate is 30% of eligible home improvements made during the year, with an annual maximum of $1,200.

c. There are limits on individual items of home improvement, with the aggregate still limited to $1,200. The limits are $250 for an exterior door; $500 for all exterior doors; $600 for exterior windows and skylights, central air conditioners, electric panels and certain related equipment, natural gas, propane, or oil furnaces, or hot water boilers; $150 for home energy audits; and $2,000 on electric or natural gas heat pumps, water heaters, and biomass stoves and boilers.

d. The $2,000 limit for electric or natural gas heat pumps, water heaters, and biomass stoves and boilers is an exception to the $1,200 overall limit.

4460.23 **Residential clean energy credit:** This is a credit for the purchase of solar electric property, solar water heating property, fuel cells, geothermal heat pump property, small wind energy property, qualified biomass fuel property, and qualified battery storage technology with a capacity of 3 kilowatt hours or more.

a. Biomass furnaces and water heaters are not eligible for this credit.

b. The credit is in the amount of 30% through December 31, 2032, 26% in 2033, and 22% in 2034. The credit expires after December 31, 2034.

4460.24 **Clean vehicle credit:** This credit provides an up to $7,500 maximum credit on qualifying clean vehicles (CV) purchased.

a. CVs that meet the critical minerals requirement are eligible for a $3,750 credit.

(1) The minerals requirement requires the battery to contain a threshold percentage in value of critical minerals that are extracted or processed in a country the United States has a free trade agreement with or are recycled in North America.

(2) The threshold percentages are 40% in 2023, 50% in 2024, 60% in 2025, 70% in 2026, and 80% after 2026.

b. CVs that meet the battery components requirement are eligible for a $3,750 credit.

(1) The battery component requirement requires that a threshold percentage of battery components are manufactured or assembled in North America.

(2) The battery threshold percentages are 50% in 2023, 60% in 2024, 60% in 2025, 70% in 2026, 80% in 2027, 90% in 2028, and 100% after 2028.

c. CVs include plug-in electric vehicles with a battery capacity of 7 kilowatt hours or better and fuel cell vehicles.

d. The CVs must have final assembly in North America to qualify for the credit.

e. Taxpayers with modified AGI in excess of $150,000 ($300,000 for married filing jointly filing status, $225,000 for head of household filing status) are not eligible for the CV credit.

f. Only vans, SUVs, or pickup trucks with MSRP (manufacturer-suggested retail price) of less than $80,000 are eligible, and only sedans and compact cars with MSRP of less than $55,000 are eligible.

g. Beginning in 2024, taxpayers can elect to transfer their CV credit to the dealer.

h. The CV credit does not apply for vehicles acquired after December 31, 2032.

i. For previously owned CVs:

(1) the credit is limited to $4,000 and 30% of the vehicle’s purchase price.

(2) the credit is disallowed for taxpayers with modified AGI above $75,000 ($150,000 for married filing jointly filing status, $112,500 for head of household filing status).

4460.25 **Commercial clean vehicle credit:** This is a credit for qualified commercial clean vehicles (CV) placed in service.

a. The credit is the lesser of:

(1) 15% of the vehicle’s cost (30% for vehicles not powered by gasoline or diesel fuel) or

(2) the incremental cost of the vehicle compared to a comparable non-CV.

b. The maximum credit is $7,500 for vehicles weighing less than 14,000 pounds and $40,000 for vehicles weighing at least 14,000 pounds.

c. The credit does not apply to vehicles acquired after December 31, 2032.

4460.26 **Carbon capture credit:** The Inflation Reduction Act (IRA) of 2022 extends and enhances the carbon capture credit, which provides for a tax credit for capturing and sequestering carbon. The taxpayer can elect the credit to be refundable and/or transferable.

4460.27 **Energy-efficient home credit:** Beginning January 1, 2023, and extending to December 31, 2032, there is a credit of $2,500 for single-family and manufactured homes when constructed according to the standards set by the Energy Star Residential New Construction Program or the Manufactured Homes Program.

a. A $5,000 credit exists for single-family and manufactured homes when they are certified as a Department of Energy (DOE) Zero Energy Ready Home (ZERH), which is a home that is so energy-efficient that a renewable energy system can offset all or most of its annual energy consumption.

b. For multifamily homes, a $500 (Energy Star certified) or $1,000 (ZERH certified) credit is allowed.

4460.28 **Domestic employees:**

a. Gross amounts of domestic wages paid in cash (in excess of $2,600 for 2023), and payroll taxes thereon, must be reported to the taxing authorities.

b. Usually, Social Security and Medicare withholdings are reported on IRS Form 941. Form 1040, Schedule H, may be used to report federal employment taxes on cash wages paid to household employees. Federal employment taxes that may be paid with Schedule H include Social Security, Medicare, withheld federal income, and federal unemployment (FUTA) taxes.

c. Wages paid for domestic services are subject to federal unemployment tax if they exceed $1,000 per quarter for 2023, aggregating wages paid to all employees. The employer's required payment for federal unemployment (FUTA) tax cannot be withheld from the employee's wages; it must be paid from the employer's own funds.

d. The employee's share of the Social Security and Medicare tax can be withheld from the domestic service employee's wages.

e. Withholding federal income taxes for household employees is required only if requested by the employee and agreed to by the employer. Such withholding would be reported on Schedule H and filed with Form 1040.

4460.29 **Excise tax on drug companies:** Drug manufacturers, producers, and importers who fail to enter into drug pricing agreements may be subject to an excise tax.

a. The excise tax rate ranges and is based on the length of noncompliance.

b. The earliest date the excise tax could apply is October 2, 2023.

c. The excise tax does not apply to exported drugs.

4460.30 **Self-employment tax** must be paid as an addition to the tax if net earnings from self-employment are $400 or more. A completed Schedule SE (IRS Form 1040) is included with the self-employed person’s income tax return.

Although the net self-employment earnings base changes annually, the tax rate remains constant at 15.3%. This is 12.4% for Old Age, Survivor, and Disability Insurance (OASDI) and 2.9% for the Hospital Insurance Plan (HIP). The maximum amount of income subject to this tax varies according to the type of insurance.

Type of Insurance		2023 Maximum Base
OASDI	at 12.4%	$160,200
HIP	at 2.9%	No Limit

An additional Medicare (HI) surtax of 0.9% is imposed on individual taxpayers on self-employment income for the tax year in excess of:

$250,000	for married persons filing jointly
$125,000	for married persons filing separately
$200,000	in all other cases

4460.31 Safe harbor requirements for individual estimated tax payments to avoid penalties: Taxpayers can avoid underpayment penalties if their withholdings and estimated tax prepayments are greater than or equal to one of the following:

a. 90% of their current tax liability or

b. 100% of their previous-year tax liability (110% for individuals with AGI over $150,000)

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Section 4500
Federal Taxation of Entities (Including Tax Preparation) (23%–33%)

4510 Differences Between Book and Tax Income (Loss)

4511 Reconciliation of Book Income to Taxable Income

4511.01 Required reconciliations:

a. As part of the corporate tax return, corporations must reconcile the difference between taxable income and accounting income on Schedule M-1. As a general rule, corporations are not required to file Schedules L, M-1, and M-2 if their total assets at the end of the taxable year **and** the corporation's total receipts for the tax year are less than $250,000.

(1) Some of the areas where differences may arise include depreciation, life insurance premiums and proceeds, tax-exempt income, expenses of tax-exempt income, capital losses, goodwill, business meals and entertainment, penalties, and federal income taxes.

(2) **Summary of Schedule M-1:**

	Net income per books (after taxes)
Add:	Federal income tax
	Net capital loss
	Taxable income not recorded on the books
	Book expenses not deducted on the return
Deduct:	Book income not subject to tax
	Deductions on the return not recorded on the books
=	Taxable income (before net operating loss deduction and dividends-received deduction)

b. Corporate taxpayers must also reconcile the opening and closing balances in retained earnings on Schedule M-2.

4511.02 Reconciling items:

Item	Book	Tax
Interest earned on municipal bonds	Include in revenues	Nontaxable
Interest expense on debt to finance the purchase of municipal bonds	Include as an expense	Nondeductible
Life insurance proceeds payable to the entity	Include in revenues	Nontaxable
Life insurance premiums on officers	Expensed	Nondeductible
Fines and penalties	Expensed	Nondeductible
Depletion	Cost depletion only	Percentage depletion
Dividends-received deduction	None	A percent of the dividend received is allowed as a deduction
Gross profit on installment sales	Income in the year of sale	Income as cash is collected
Investment income	Recognized as income under the equity method	Recognized as dividends are received

Item	Book	Tax
Depreciation	Expensed over a longer period of time	Expensed over a shorter period of time using MACRS
Prepaid rent, interest, royalties	Income when earned	Income when received
Warranty expenses, bad debt expense	Estimated and expensed	Deducted as actually incurred
Lobbying expenses	Expensed	Generally nondeductible
Patents	Amortized over 20 years with full deduction in the year it becomes obsolete	Amortized over 15 years beginning in the month acquired
Copyrights	Amortized over the life of the author plus 70 years with full deduction in the year it becomes obsolete	Amortized over 15 years beginning in the month acquired
Goodwill	Carrying value adjusted only when goodwill is impaired	Amortized over 15 years beginning in the month acquired
Business meals	100% deductible	50% deductible
Capital losses	Deductible	Nondeductible; only can offset capital gains; carry back 3 years, carry forward 5 years

4512 Disclosures on Schedule M-3

4512.01 Corporations, and related groups of corporations, with total assets between $10 million and $50 million are allowed to file Schedule M-1 in place of Parts II and III of Schedule M-3. Corporations and related groups of corporations with more than $50 million in assets must reconcile financial statement net income to the net income or loss of the corporation reported for U.S. taxable income using Schedule M-3. (IRS Form 1120, Schedule M-3 is used instead of M-1.)

4512.02 Check-off of types of return for the corporation:

a. Nonconsolidated return

b. Consolidated return (IRS Form 1120 only)

c. Mixed 1120/L/PC group

d. Dormant subsidiaries attached

4512.03 Part 1, Schedule M-3: Type of report filed by the corporation:

a. SEC Form 10-K

b. Income statement that was:

(1) certified audited and

(2) nontax basis

c. Income statement that was:

(1) not certified audited and

(2) nontax basis

d. Enter the date for the income statement period:

(1) Has the income statement been restated?

(2) Has the income statement been restated in the previous five periods?

e. Is any of the corporation's voting common stock publicly traded?

f. Enter the symbol for the corporation's stock that is:

(1) the primary corporate stock,

(2) U.S. publicly traded, and

(3) voting common stock.

g. Enter the nine-digit CUSIP number of the corporation's stock that is:

(1) the primary corporate stock,

(2) publicly traded in the United States, and

(3) voting common stock.

4512.04 Part 1, continued: Reconciliation of statement income to taxable income:

a. Post the worldwide consolidated net income.

b. Check off the accounting standard used:

(1) GAAP

(2) IFRS

(3) Statutory

(4) Tax-basis

(5) Other

c. Nonincludible foreign entities:

(1) Net income

(2) Net loss

d. Nonincludible U.S. entities:

(1) Net income

(2) Net loss

e. Net income or loss from other includible:

(1) Foreign disregarded entities

(2) U.S. disregarded entities

(3) Other includible entities

f. Adjustments to eliminations of transactions between includible and nonincludible entities

g. Other adjustments

4512.05 Part II: Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations with Taxable Income per Return—Income (Loss) items: Part II includes lines for reconciling income items.

4512.06 Part III: Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations with Taxable Income per Return—Expense/Deduction Items: Part III includes lines for reconciling expense items.

4513 Reporting Uncertain Tax Positions on Schedule UTP

4513.01 Since tax year 2010, IRS Schedule UTP has been required from some corporations to report uncertain tax positions.

4513.02 Corporations filing Forms 1120, 1120-F, 1120-L, or 1120-PC must file Schedule UTP if total assets equal or exceed the applicable asset threshold for the tax year and the corporation reserved for a tax position in audited financial statements.

4513.03 For tax years beginning in 2014 and later, the asset threshold for reporting uncertain tax positions on Schedule UTP (Form 1120) is $10 million.

4513.04 Corporations meeting all Schedule UTP filing requirements must file a Schedule UTP and provide "concise descriptions" of uncertain tax positions and the nature of the issues, including a description of the relevant facts.

For further guidance on Schedule UTP, see sections **4132.04–.06.** Guidance for "concise descriptions" for Schedule UTP can be found at the IRS website.

4520 C Corporations

4521 Computations of Taxable Income, Tax Liability, and Allowable Credits

4521.01 Corporations are taxable entities—they must file tax returns and pay taxes.

a. Other organizations taxed as a corporation include insurance companies, business trusts, associations, and joint stock companies.

b. An unincorporated organization can be taxed as a corporation if it elects to be taxed as a corporation. The election is made on IRS Form 8832 (*Entity Classification Election*).

c. Certain corporations are tax-exempt.

d. C corporations not expressly exempt from income tax must file an annual tax return (Form 1120) by the 15th day of the **fourth** month after the end of the tax year. (The former deadline was the 15th day of the third month, so this amounts to an extension of one month for C corporation returns.)

e. The deadline changes generally went into effect for tax years beginning after December 31, 2015. However, for C corporations with a June 30 year-end, the changes were not effective until tax years beginning after December 31, 2025.

f. Estimated tax payments for corporations are due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. The total estimated payments should equal the lesser of 100% of the tax shown on its prior-year return or 100% of the tax due on its current-year return.

4521.02 The following tax formula is for corporations. Each step in the formula must be completed before the succeeding step is considered.

	Total income
–	Exclusions
=	Gross income
–	Deductions (other than charitable contributions and the dividends-received deduction)
=	Taxable income before special deductions
–	Charitable contributions (limited to 10% of taxable income before charitable contribution deduction)
=	Taxable income before the dividends-received deduction
–	Dividends-received deduction
=	Taxable income
×	Tax rate (a flat 21% under the Tax Cuts and Jobs Act of 2017)
=	Tax liability before additions and credits
+	Additions to tax
–	Credits against tax
=	Tax liability

4521.03 **Gross income** for the corporation is determined in approximately the same manner as for the individual.

a. A corporation must include in gross income 100% of the dividends received from other corporations.

b. No gain or loss is recognized on the sale or acquisition of the corporation's own capital stock.

c. A corporation distributing appreciated property to its shareholders will be taxed on the appreciation.

d. If the corporation is on the accrual basis, income must be reported in the year all events have occurred that determine the corporation has the right to receive it **and** the amount can be determined with reasonable accuracy, even though some or all of it is received in a later year. To calculate the amount to be included in income, the rule is:

(1) the right to receive the income is not contingent on a future event,

(2) the amount can be reasonably estimated, and

(3) there must be a reasonable expectation that it will be received in due course.

4521.04 **Deductions from gross income** (other than contributions and dividends received) include expenses that are normally deducted from gross income by an individual. However, no deduction is allowed for capital losses in excess of capital gains.

a. Losses can only be used to offset capital gains in carryover years.

(1) Corporate capital losses carry back three years and forward five years as short-term capital losses.

(2) Capital loss carrybacks and carryforwards are short term.

(3) A dividends-received deduction may be limited by taxable income (see section **4521.05**).

(4) Small businesses are those whose average annual gross receipts in the last three years were $27 million or less in 2022 (subject to annual inflation adjustments). (Tax Cuts and Jobs Act of 2017 (TCJA))

b. Net operating loss (NOL) is calculated as the excess of operating deductions over operating income for a given year. Generally, for years starting after January 1, 2018, the TCJA disallowed an NOL carryback. Net operating losses were also limited to 80% of taxable income, but the carryover period was extended indefinitely.

c. A deduction for compensation paid or accrued with respect to a "covered employee" of a publicly held corporation is limited to no more than $1 million per year. Recently, the American Rescue Plan modified IRC Section 162(m) for tax years beginning 2027, to treat the five next highest compensated individuals as "covered employees" as described in Section 162(m)

d. For tax years beginning after 2017, no deduction is allowed for "entertainment" expenses, and while 50% of business meals are deductible, that cost should be clearly separated from entertainment (Tax Cuts and Jobs Act of 2017 (TCJA)).

4521.05 Special deductions for corporations:

a. Charitable contributions:

(1) The corporate limit for charitable contributions is 10% of taxable income computed before the deductions for contributions and the dividends-received deduction and before consideration of any capital loss *carryback.*

(2) Contributions in excess of the 10% limit may be carried forward five years.

(a) The total contribution deduction for any year into which an unused contribution is carried is still limited to 10% of the applicable income figure for that year.

(b) Carryovers are considered in the order in which they arose.

(3) Accrual-basis corporations may accrue contributions if the commitment was made before year-end and the contribution is paid within 2-1/2 months after the close of the tax year.

(4) Cash-basis corporations may deduct only those amounts actually paid out, increased by any carryovers that might be available.

b. Dividends-received deduction:

(1) A corporation may deduct a percentage of the dividends it receives from taxable domestic corporations. The amount of the dividends-received deduction is based on the shareholder corporation's percentage of ownership in the corporation making the dividend distribution. The percentage of the dividend received that is deductible is determined as follows in tax years beginning after December 31, 2017:

Ownership	Deduction Percentage
Less than 20%	50%
20% or more, but less than 80%	65%
80% or more	100%

(a) The deduction for shareholders that qualify for either the 50% or 65% deduction is further limited to 50% or 65% of taxable income computed before the deduction for dividends received and before any deduction for net operating loss carryforwards.

(b) This limit does not apply, however, if in deducting 50% or 65% of the dividends received, a net operating loss is either created or increased.

(c) If corporations owning shares are entitled to both 50% and 65% deductions for dividends received from different companies, the 65% dividends-received deduction is calculated first. When calculating the 50% deduction limitation, the *total* amount of dividends received from 20%-owned companies is subtracted from taxable income.

(2) The dividends-received deduction for dividends received from an affiliated company is equal to 100% of the dividends received.

(a) An affiliated group exists where:

i. a parent company owns at least 80% of the stock in at least one other corporation in the group or

ii. at least 80% of the stock of other companies in the group is owned directly by one or more companies in the affiliated group. (The 80% stock ownership test does not apply to nonvoting stock that is limited and preferred as to dividends.)

(b) Members of an affiliated group may elect to file a consolidated return if all members consent. In this situation, dividends paid among the members are eliminated from income.

(3) Dividends qualify for the dividends-received deduction only if the 46-day (or 91-day) holding period is met for **each** dividend received. The holding period must be met within the 91-day period beginning 45 days before the ex-dividend date of the stock. If the stock is cumulative preferred stock with an arrearage of dividends, it must be held at least 91 days during the 181-day period beginning 90 days before the ex-dividend date.

Days when the corporation is protected from loss on the stock by put options do not count toward the holding period requirement. The holding period requirement must be met for each dividend viewed over time.

4521.06 **Tax rates for corporations:**

a. Taxable corporations are subject to a 21% tax on taxable income in tax years beginning after December 31, 2017, per the Tax Cuts and Jobs Act of 2017 (TCJA). This rate change affected a number of other provisions, including the treatment of accumulated earnings, capital gains, tax normalization by public utilities, and dividends received from other corporations.

b. The tax rate for qualified personal service corporations is a flat 21% on all taxable income.

Net Operating Losses and Capital Loss Limitations

4521.07 A corporation's net operating loss (NOL), arising in tax years beginning after December 31, 2017, may be carried forward an unlimited number of years at 80% of taxable income per year. The Tax Cuts and Jobs Act of 2017 (TCJA) repeals the two-year carryback for most businesses. An exception is provided to allow a two-year carryback for farming and casualty insurance businesses.

4521.08 A corporation's NOL is the excess of ordinary deductions over gross income (negative taxable income) without considering capital gains and losses.

4521.09 As with many complex parts of federal tax law, the IRS has prepared guidance in the form of a publication devoted to explaining how to comply. In this case, Publication 536 provides step-by-step instructions for calculation of an NOL.

4521.10 A C corporation's capital losses are determined separately from NOLs and may only offset capital gains. IRS Publication 542 includes instructions for determining and accounting for a corporation's capital loss.

4521.11 An excess of capital loss over capital gain in a "loss year" may be carried back to each of the three tax years preceding the year of loss and forward to the five years following the "loss year." In each case, the loss is absorbed by the oldest gain first.

4521.12 Losses from expropriation of corporate assets by a foreign government are calculated separately and subject to different carryover rules.

4522 State and Local Tax Issues

4522.01 Taxpayers often focus on the impact of federal taxation and taxes imposed by state and local jurisdictions. Nonresidents are taxed on their U.S. income. A state cannot tax a nonresident unless the nonresident has a necessary connection with the state. The connection necessary for a state to tax a nonresident is called "nexus."

4522.02 Apportionment is required when an entity does business in more than one state. What creates and constitutes nexus varies from state to state. Economic nexus is a concept that is generally based on whether a business has an economic presence or market in a particular state. Currently, 44 out of 50 states have economic nexus laws.

a. Nexus can be created for income tax purposes or sales tax purposes. Activities that may create nexus for **income tax purposes** are:

(1) deriving income from sources within the state (selling services, providing services in the state).

(2) accepting orders in the state.

(3) delivery of property into the state on company vehicles.

(4) accepting deposits in the state.

(5) having inventory in the state.

(6) owning or leasing property.

(7) employing workforce that is engaged in activities that exceed "mere solicitation".

(8) Has capital assets or property located there: offices, warehouses, delivery centers, etc.

b. Some states seeking to gain revenue from out-of-state companies targeting customers within their borders have enacted a variety of economic nexus laws. Some states use bright-line threshold based on factor presence (amount of payroll and/or sales in state) that when exceeded, automatically creates income tax nexus. Other states, use a more broadly worded concept of "doing business" which analyzes the facts and circumstances of a taxpayer's activities direct to the state.

c. Nexus for **sales tax purposes** may be generated when the business has:

(1) a physical location in the state

(2) resident employees working in the state

(3) property, including tangible property, within the state

(4) employees who regularly solicit business there

d. Before the case ruling *South Dakota v. Wayfair,* physical presence was one of the prevalent factors in determining whether a business would create a sales tax nexus in a state. In this 2018 ruling, the Supreme Court denounced the old nexus determination rules as artificial and anachronistic. The Court indicated that states have a right to require online sellers to charge and collect sales tax from online buyers, not just those who are physically located in that state.

e. Please note that the following activities do **NOT** create nexus for income tax purposes, as described in Public Law 86-272:

(1) solicit sales of tangible personal property (directly or indirectly).

(2) provide services that are ancillary to the sale of property.

(3) have samples for display in the state and have other property sued for sale in the state.

(4) orders are accepted and fulfilled outside the state.

f. Whereas *South Dakota v. Wayfair* was a landmark case that ruled in regard to sales taxes, many states' economic nexus laws emulate the same concepts when determining whether an income tax nexus is also created, thus rendering the old "physical presence" requirement obsolete.

g. A sound tax planning practice for businesses that develop a wider clientele base in a certain state, especially when it comes to services delivered online or online sales, is to check whether that particular state adopted economic nexus laws and the applicable criteria.

h. Generally, states source revenue flowing from the sales of services based on two main methodologies:

(1) Cost of performance: Under a strict approach, revenue is apportioned to the state where the costs associated with the income-producing activity are incurred. If the activity is performed across multiple states, the revenue is apportioned entirely to the state in which the greatest proportion of revenue was earned.

(2) Market-based: Service revenue is allocated to the state in which the benefit of the service is received and subsequently used. Although this approach applies to many types of revenue, it does not apply to sales of tangible personal property. In general, state economic nexus statutes require some minimum amount of revenue linked to the particular state before nexus is established.

i. Once it is determined that nexus was created in a state, the corporation must file a tax return in that jurisdiction and apportion its income and expenses. Rules or laws are created to allocate or apportion the taxes to the correct states according to how the tax should be distributed.

j. Apportionment is a four-step process:

(1) Determine federal taxable income.

(2) Determine the percent of income to be apportioned to each state.

(3) For each state to which income must be apportioned, make adjustments to federal taxable income to apply state rules to such items as recognition of the IRC Section 179 deduction/bonus depreciation, use of the cash method of accounting, and limitations on deduction of fringe benefits to determine income subject to apportionment according to that state's rules on what is income.

(4) Apply the apportionment percentage to the state's taxable income.

k. This can, and frequently does, result in total taxable income for state purposes being more or less than federal taxable income.

4522.03 State and local taxes

a. Local jurisdictions in all 50 states impose real estate taxes on the real property located within the boundaries of the jurisdiction. This tax is generally imposed on an annual basis, based on the real estate tax year, and is computed based on the value of the property.

b. Most of the states also allow local jurisdictions to impose a local tax on personal property. These personal property taxes vary significantly from state to state as to the rate of taxation as well as to the type of personal property subject to the tax. Typical types of property that may be subject to a personal property tax include:

(1) automobiles,

(2) stocks and bonds, and

(3) tangible business property such as inventory, machinery, or equipment.

c. State governments generally impose a statewide general sales tax on the sale of personal property and, in some cases, certain types of services. This tax is usually based on a percentage of the retail sales price of the goods or services.

d. States that impose a general sales tax also impose a use tax. The state use tax applies when a taxpayer purchases goods outside the state and therefore did not pay the home state's sales tax. Generally, a taxpayer may receive a credit against the use tax for the amount of sales tax paid out of state.

e. Most states also impose some type of personal income tax on individuals. The rates of these taxes vary greatly and the manner in which the state income tax is computed varies from state to state. Many states also allow local jurisdictions to impose a personal income tax.

f. Corporate income tax is also imposed by most states. The tax is generally imposed on the corporation's income that is attributable to that particular state. State corporate income tax rates vary greatly, with most states having a flat rate structure.

4530 S Corporations

4531 Eligibility and Election

4531.01 Certain domestic corporations may elect not to be taxed. Instead, the income is passed through to the shareholders, who are taxed on their share of the corporation's earnings.

a. Shareholders who held stock during the taxable year must consent to the election.

b. All shareholders on the date of the election must consent to the election.

c. The election will be considered timely if it is made within 2-1/2 months of the first day of its taxable year.

d. Effect of election:

(1) Shareholders are taxed on their share of the earnings even though the earnings are not distributed.

(2) In S corporations, FICA taxes apply only to designated salaries, and the corporation is responsible for paying the taxes. No FICA taxes are paid on the remaining ordinary income that passes to the owners.

(3) S corporations must file IRS Form 1120S each year before the 15th day of the third month following the close of the taxable year.

(a) Filing IRS Form 7004 will automatically extend the filing date for six months.

(b) If estimated tax liability is expected to be $500 or more, an estimated tax payment must be paid.

(4) S corporations may be part of an affiliated group, but a consolidated return is prohibited.

4531.02 The following requirements must be met before a corporation is eligible to elect S corporation status:

a. S corporations are limited to a maximum of 100 shareholders. Family members can elect to be treated as one shareholder.

(1) Family members include a common ancestor, his or her descendants, and the spouses (or former spouses) of the descendants.

(2) The common ancestor cannot be more than six generations removed from the youngest generation of shareholders.

(3) Two spouses are counted as a single shareholder.

(4) The individual, not the trust, is considered as the shareholder. This is considered when a trust is owned by an individual.

b. All shareholders must agree to the S corporation election.

c. Only one class of stock may be issued and outstanding. Differences in voting rights among shares of common stock will be allowed, however.

d. Only individuals, estates, certain trusts, and charitable organizations may be shareholders.

(1) Certain qualified retirement plan trusts and certain charitable organizations that are exempt from tax are eligible to be shareholders. The income from these will pass through to the shareholder as unrelated business taxable income (UBTI).

(2) A qualified Subchapter S trust (QSST) may be shareholder for two years beginning with the date of death of the owner.

e. The election (IRS Form 2553) may be made at any time during the prior year or on or before the 15th day of the third month of the election year. However, the IRS has the authority to waive this requirement.

f. Only eligible domestic corporations may qualify. Ineligible corporations include the following:

(1) Certain financial institutions, but not banks

(2) Most insurance companies

(3) A current or former domestic international sales corporation (DISC)

(4) A company electing the Puerto Rico and possessions tax credit

g. Nonresident aliens are not allowed as shareholders. Nonresident aliens are allowed to be beneficiaries of an electing small business trust (ESBT).

4531.03 S corporation status may be terminated voluntarily or involuntarily (i.e., revoked by operation of law).

a. *Voluntary termination, or revocation,* may take place if shareholders owning more than 50% of the *outstanding* shares (including nonvoting shares) consent and file notice of revocation. If a company has both voting and nonvoting shares of the same type of stock, then more than 50% of the *total* number of outstanding shares is required for voluntary termination.

(1) If the notice is filed on or before the 15th day of the third month of the taxable year, it can be effective for the entire year or as of some specified date.

(2) If filed after this date, the termination becomes effective the following year.

(3) A new shareholder owning more than 50% of the voting stock may terminate S corporation status within 60 days of becoming a shareholder. This termination is effective on the day it occurs.

b. *Involuntary termination* (revocation by operation of law) becomes effective on the day when any of the following events occur:

(1) The number of stockholders exceeds the limit allowed by law.

(2) More than one class of stock is outstanding.

(3) A corporation, nonpermitted trust, or partnership becomes a shareholder.

(4) A complex trust becomes a shareholder.

(5) A nonresident alien becomes a shareholder.

c. Since termination or revocation is effective as of the date the corporation ceases to qualify as an S corporation, the result is ordinarily two short tax years. That will require a short-period Form 1120S and a short-period Form 1120. The corporation's year-end will not change as a result of a change in status.

d. Generally, there is no passive investment income limitation for S corporations; however:

(1) if an S corporation has C corporation (regular corporation) earnings and profits and more than 25% of its gross receipts for three successive years is from certain forms of passive income, S corporation status will be terminated as of the first day of the fourth year.

(2) excess net passive investment income is also subject to income tax levied on the corporation at the highest corporate tax rate in effect.

e. If S corporation status is voluntarily terminated there is a five-year waiting period, or consent of the IRS must be secured, before the S status may be reelected.

4531.04 An S corporation must generally use the calendar year as its tax year. A fiscal year may be adopted if the corporation can establish a sound business purpose for such a year or show that the tax deferral would not exceed three months.

4532 Determination of Ordinary Business Income (Loss) and Separately Stated Items

4532.01 Generally, the S corporation is not subject to income tax. The company's nonseparately stated taxable income or loss flows through to the shareholders, is reported to them on Schedule K-1 of IRS Form 1120S, and is also reported by them on their individual income tax returns.

4532.02 Taxable income items for the S corporation are determined in almost the same way as for a partnership. Allowable deductions are similar to those available to individuals, with the following exceptions:

- **a.** Itemized deductions
- **b.** Net operating loss deductions
- **c.** Charitable contributions
- **d.** Foreign taxes
- **e.** Oil and gas depletion

4532.03 Certain items, the "separately stated items," are reported to the individual shareholders to be included in their income tax returns because they are subject to special treatment, most often limitations. These items include the following:

- **a.** Tax-exempt income
- **b.** IRC Section 1231 gains and losses
- **c.** Long-term and short-term capital gains and losses
- **d.** Charitable contributions
- **e.** Passive income (loss)
- **f.** Portfolio income (loss)
- **g.** IRC Section 179 expense deduction
- **h.** Nonbusiness income or loss
- **i.** Intangible drilling costs
- **j.** Mining exploration expenditures
- **k.** Depletion
- **l.** Amortization of reforestation expenditures
- **m.** Discharge of indebtedness
- **n.** Investment income and expenses
- **o.** Recoveries of prior taxes, bad debts, and delinquency amounts
- **p.** Wagering gains or losses
- **q.** Gain or loss on sale of collectibles
- **r.** IRC Section 199A income (income from any and/or each qualified trade or business (QTB))
- **s.** IRC Section 199A W-2 wages (wages paid to persons working in a QTB)

t. IRC Section 199A unadjusted basis (original cost of tangible property used in a QTB)

u. IRC Section 199A REIT dividends (any ordinary dividends received from a real estate investment trust)

v. IRC Section 199A PTP income (any item of income from a publicly traded partnership)

4532.04 Also listed separately are the following:

a. Tax credits

b. Tax preferences and AMT (alternative minimum tax) adjustment items

c. Foreign taxes

4532.05 The Tax Cuts and Jobs Act of 2017 (TCJA) includes a special deduction: the IRC Section 199A qualified business income deduction (QBID). The deduction, equal to 20% of qualified business income from the S corporation's trade or business income, is claimed on the individual shareholder's federal income tax return (IRS Form 1040). The last five items in the list in section **4532.03** relate to this new deduction.

4532.06 Each shareholder must include on their personal tax return the share of the corporation's income or loss and special items from the corporate tax year that has ended with or within the personal tax year. Thus, income is recognized on a basis similar to that of partnerships.

a. When ownership has changed during the year, each owner must recognize a pro rata share of the income or loss allocated on a daily basis.

b. Loss pass-throughs in excess of the taxpayer's basis in the corporation may be carried forward indefinitely and deducted when the taxpayer's basis has increased sufficiently to absorb the loss.

4532.07 **Accumulated adjustments account (AAA)**

a. If an S corporation previously operated as a C corporation and had accumulated earnings and profits (E&P) while operating as a C corporation, then the S corporation must keep track of the accumulated adjustments account (AAA) which determines the taxability of distributions.

b. The cumulative income (loss) for the period the corporation has operated as an S corporation is calculated as follows:

	AAA at beginning of year
+/–	Separately stated items (excluding tax-exempt income)
+/–	Ordinary income/losses
–	Nondeductible, noncapital expenditure expenses (excluding expenses to generate tax-exempt income)
–	Distributions from AAA
=	AAA at end of year

4533 Basis of Shareholder's Interest

4533.01 A shareholder's tax basis in an S corporation is increased by any stock purchases and capital contributions. The following items also cause an adjustment to basis. However, a shareholder's basis in an S corporation can never go below zero.

a. Upward adjustments (shareholder's share of the following items):

(1) Ordinary income

(2) Separately stated income items

(3) Depletion in excess of the property's basis

(4) Tax-exempt income

b. Downward adjustments (shareholder's share of the following items):

(1) Ordinary losses

(2) Separately stated loss items

(3) Nondividend distributions

(4) Nondeductible expenses

(5) Depletion for oil and gas

c. The qualified business income deduction (IRC Section 199A) does not affect the basis of a shareholder's interest.

d. While an S corporation shareholder does not get basis for debt, they are allowed a separate debt basis for loaning money directly to the S corporation. Losses first offset tax basis in stock and then debt basis. In the future, any increase in basis first restores debt basis and then stock basis. Any repayment of debt to the shareholder reduces the shareholder's debt basis.

4540 Partnerships

4541 Determination of Ordinary Business Income (Loss) and Separately Stated Items

Administrative Development

4541.01 The Bipartisan Budget Act of 2015 (BBA) introduced a new system for tax audits of partnerships and for partnerships to report their income, including requiring a partnership representative to deal with the IRS during an audit of the partnership. The BBA audit regime, generally effective for partnership tax years beginning after December 31, 2017, is a change from the TEFRA (Tax Equity and Fiscal Responsibility Act) partnership audit procedures it replaced. The BBA regime replaces TEFRA.

a. The new rules apply to all partnerships in tax years beginning after December 31, 2017, unless the partnership has fewer than 100 partners and elects out of the new rules.

b. Rules discussed in this section (section **4540**) relating to accounting for partnership items, maintenance of capital accounts, determining a partner's basis, and transactions between a partner and the partnership are not changed by the new rules.

c. What is changed is that the partnership can be the taxpayer, accounting for after-tax income to the partners. An IRS audit can now focus on income adjustments and collection of any additional tax assessed at the partnership level unless the partnership has elected to remain subject to the TEFRA rules.

Partnerships under the centralized partnership audit regime are not able to file amended returns, and instead must file administrative adjustment requests (AARs). When an AAR results in an underpayment, the partnership can pay the amount due or can push out the amount due to partners at the partner level. On the other hand, if an

AAR results in an overpayment, refunds generally are not available, and partners must take into account adjustments in the year they received them.

4541.02 Beginning in 2018, the IRS requested that partnerships whose members' tax capital balances were negative be disclosed separately, on box 20 of Schedule K-1 (IRS Form 1065), using code AH. Beginning in 2019, the IRS extended this requirement to report the partners' capital balances on a tax basis to all the partners, regardless of whether their balances were negative or positive. In response to the taxpayers' and practitioners' many requests, the IRS decided to postpone this requirement to 2020 filing periods and beyond. Going forward, the only acceptable reporting method for partners' capital accounts will be on a tax basis, using the transactional method.

Special provisions and methods are prescribed for partnerships that did not report, nor kept partners' capital accounts on a tax basis for books and records in determining the beginning balance. In those cases when partnerships did not employ the tax basis method for calculating partners' capital accounts, partnerships may choose one of three methods to compute the beginning balance:

1. Modified outside basis method

2. Modified previously taxed capital method

3. IRC Section 704(b) method

Under the transactional method, the formula for calculating a partner's ending capital balance would be:

	Beginning balance
+	Capital contributions
+/–	Current-year income
+/–	Other increases/(decreases)
–	Withdrawals/distributions
=	Ending capital balance

a. Capital contributed during the year would be cash plus the adjusted tax basis of all property contributed by the partner to the partnership during the year, reduced by any liabilities assumed by the partnership.

b. Current net year income (loss) constitutes the partner's distributive share of partnership income and gain (including tax-exempt income) as figured for tax purposes for the year, minus the partner's distributive share of partnership loss and deductions (including nondeductible, noncapital expenditures) as figured for tax purposes.

c. Other increases/(decreases) would represent the sum of all other increases or decreases that affected the partner's capital account for tax purposes during the year. Partnerships should attach a statement explaining each adjustment.

d. Withdrawals and distributions report the amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year.

e. Ending capital represents the sum of all the items enumerated above.

Partnership Characteristics (Before the Bipartisan Budget Act of 2015)

4541.03 Partnerships have not generally been thought of as taxable entities. They have been reporting entities. Partnerships have functioned as a conduit for income tax purposes.

a. Ordinary income and losses along with special gain and loss items flow through the partnership down to the individual partners, who report these items on their personal tax returns.

b. The partnership must report each partner's distributive share of the ordinary gain or loss as well as any separately stated items required to properly calculate taxable income in the partner's return.

c. Self-employment taxes apply to all ordinary income passing to the owners.

d. The partnership may owe a penalty for late filing of the partnership return. The amount of the penalty in 2023 is $220 per partner for each fraction of a month the return is late up to a maximum of 12 months.

4541.04 **A partnership** is created when two or more persons join together to conduct a business activity, the expected profits and losses of which will be shared in some manner by those persons.

a. Organizations qualifying as a trust, estate, or corporation will not be treated as a partnership.

b. Unincorporated entities that are eligible to be treated as a partnership include the following:

(1) Syndicate

(2) Pool

(3) Group

(4) Joint venture

c. In general, entities that qualify for partnership treatment also qualify for electing out of partnership treatment under the check-the-box regulations. If a business entity is not required to be treated as a corporation for federal tax purposes, it may choose its own classification. An entity with two or more members can be classified as either a partnership or an association taxed as a corporation. An entity with only one member can be classified as an association or can be disregarded as an entity separate from its owner. A single-member limited liability company cannot elect partnership status. The default classification for a new entity with two or more members is a partnership, and the default classification for an entity with one member requires the entity to be "disregarded"—treated as a proprietorship for an individual or trust and as a branch or division for a corporation or another partnership.

4541.05 The partnership return (IRS Form 1065), filed under TEFRA (Tax Equity and Fiscal Responsibility Act) procedures, is strictly an informational return. It is not an income tax return because partnerships do not pay income taxes; however, a return is required even though the firm has no gross income. If the partnership is subject to BBA (Bipartisan Budget Act of 2015) procedures, then it will report income and pay income tax on behalf of the partners.

a. Partnerships are required to file their returns by the 15th day of the **third** month after the end of the tax year.

b. A calendar-year partnership will have to file its return by March 15 of the following year.

c. The maximum extension for partnership returns is a seven-month period ending on October 15 for calendar-year taxpayers.

Reporting Partnership Income

4541.06 The ordinary gain or loss of a partnership must be computed and then allocated to the partners according to the agreed-upon method for distributing profits and losses.

a. **Gross income:** The general rule is any item of gross income that receives special consideration on an individual's return must be excluded from ordinary gain or loss and shown as a separate item on Schedule K of IRS Form 1065. One exception is guaranteed payments, which are both deductible by the partnership and included as a separately stated item on IRS Form 1065, Schedule K-1, *Partner's Share of Income, Deductions, Credits, Etc.*

b. **Business deductions:** Partnership deductions are basically the same as an individual's deductions to determine adjusted gross income.

(1) Any deduction that receives special consideration on a partner's return must be shown as a separate item on Schedule K. Such deductions do not enter the computation of ordinary gain or loss.

(2) Included as allowable deductions are guaranteed payments to the partners for salaries and interest. Any guaranteed payment to a partner for services performed will be taxed as ordinary income and subject to self-employment tax at the partner level. (IRC Section 707)

c. **Nonbusiness deductions:** Partnerships do not include any nonbusiness deductions (e.g., standard deduction) in the computation of ordinary gain or loss.

d. **Tax accounting elections:** The following elections are made by the partnership (IRC Section 703(b)):

(1) Taxable year and accounting method

(2) Cost recovery methods and assumptions

(3) IRC Section 179 deductions

(4) Inventory method

(5) Cost or percentage depletion method for all but oil and gas wells

(6) Treatment of research and experimental expenditures

(7) Amortization of start-up expenditures and amortization period

(8) Determination of qualified production activities income (QPAI) and production-related wages for purposes of the domestic production activities deduction (DPAD)

e. **Tax accounting elections:** The following elections are made by the individual partner:

(1) The decision to reduce the basis of depreciable property when first excluding income from discharge of indebtedness

(2) The decision to claim cost or percentage depletion for oil and gas wells

(3) The decision to take a deduction or credit for taxes paid to foreign countries and U.S. possessions

4541.07 Items receiving special treatment must be separately listed in Schedule K.

a. Specially treated items in the partnership retain the same character on the tax return of the individual partners.

b. Following are some of the partnership items that must be separately listed on Schedule K:

(1) IRC Section 179 expensing deduction of business assets

(2) Dividends, interest, and royalties

(3) Net short-term capital gain (loss)

(4) Net long-term capital gain (loss)

(5) Net gain (loss) from casualty and theft

(6) Net gain (loss) for sale or exchange of "Section 1231 assets"

(7) Contributions

(8) Excess business interest expense

(9) Investment interest expense

(10) Foreign taxes

(11) Income or loss from real estate rentals

(12) Income or loss from other rentals

(13) Expenses related to portfolio income

(14) Tax-exempt interest

(15) Recoveries of items previously deducted

(16) AMT preference items

(17) Nonbusiness and personal items

(18) W-2 wages paid to workers in a qualified business

(19) IRC Section 199A income

(20) IRC Section 199A W-2 wages

(21) IRC Section 199A unadjusted basis

(22) IRC Section 199A REIT (real estate investment trust) dividends

(23) IRC Section 199A PTP (publicly traded partnership) income

c. In general, separate treatment must be accorded to any partnership item which, when treated separately, would result in a different tax liability than the partner would experience if the item had not been separately treated.

d. Using a special schedule (Schedule K-1), the partnership must disclose each partner's distributive share of the Schedule K items. Guaranteed payments (salaries/interest) are also included.

(1) The profit and loss sharing ratio is used to distribute these special items.

(2) If the income ratio is different from the loss ratio, the special items are distributed accordingly, depending on whether the partnership has a profit or loss.

4541.08 Gains, losses, depreciation, and depletion on property contributed by a partner to a partnership must be allocated in a way that takes into account the difference between the partnership's basis for the contributed property and the property's fair market value at the time of contribution to the partnership. These items cannot be allocated to the partners in accordance with each partner's interest in the partnership, but must be specially allocated to burden, or benefit, the contributing partner for the difference.

4541.09 Partnership tax years

a. **Reporting year:** Each partner must include in its tax return a share of those partnership items from the partnership tax year that ends with or within the partner's tax year.

(1) Generally, the death, retirement, or withdrawal of a partner, the sale of a partnership interest, or the addition of a new partner will not terminate the partnership tax year. However, these events will close the tax year for the individual partner affected.

Prior to passage of the Tax Cuts and Jobs Act of 2017 (TCJA), the partnership year would terminate with the sale or exchange of an aggregate interest of 50% or more in partnership capital or profits. That is no longer the case after December 31, 2017.

(a) There may, however, be adjustments to both tax basis and partners' capital accounts required by IRC Section 704(b) when a new partner is admitted to the partnership.

(b) The new partner participates in income from the time of admission to the partnership.

(c) Capital accounts of existing partners may be adjusted to reflect fair market values of partnership property when the new partner is admitted.

(d) Treasury Regulations at Section 1.704-1(b) explain these adjustments. They are considered among the most complex Treasury Regulations. Given the popularity of the partnership form of business entity, understanding those regulations is critical for any tax practitioner.

(2) Income and losses will be allocated to a new partner only for that portion of the year during which the new partner was a member of the partnership. Allocation of income and losses will not be made retroactive to a period prior to the new partner's entry into the partnership.

b. **Establishing the tax year:**

(1) Generally, the tax year of a partnership must be determined by reference to the tax years of the partners.

(a) If the majority partners (over 50% of the ownership) all have the same tax year, the partnership must adopt that tax year.

(b) If the majority partners have different tax years, the partnership must adopt as its taxable year the tax year of the principal partners. Principal partners are partners with at least a 5% interest in capital or profits.

(c) If neither the majority partners nor the principal partners have the same tax year, the partnership must adopt the tax year that results in the least aggregate deferral of income to the partners.

(d) **Exceptions:**

i. The partnership may establish that a business purpose exists for selecting another tax year.

ii. If a partnership recognizes 25% or more of its gross receipts in the last 2 months of the same 12-month period for three consecutive years, it may adopt that 12-month period as its fiscal year.

(2) Partnerships may elect to use a different tax year than the one required if the income deferral is three months or less. To make this election, the partnership must make a noninterest-bearing deposit with the government in an amount calculated to deny the partners any financial benefit from deferring recognition of income for the fiscal year.

(3) The noninterest-bearing deposit required by IRC Section 7519 to elect or retain a fiscal year that defers recognition of income for three months or less is calculated on IRS Form 8752 (*Required Payment or Refund Under Section 7519*), which is attached to the IRS Form 1065.

4542 Basis of Partner's Interest

4542.01 The basis of a partner's interest in a partnership is computed without regard to the capital account balance as shown on the partnership books.

a. A partner's basis is increased by the investment of property or cash.

(1) The increase in a partner's basis for contributed property is limited to the partner's basis in that property, resulting in a carryover basis and a carryover holding period.

(2) In addition, the basis of a partner's interest is increased by the distributive share of the following partnership items:

(a) Taxable income

(b) Tax-exempt income

(c) Excess depletion deductions

b. A partner's basis is decreased by the partner's withdrawals of money and by the adjusted basis of all other property distributed to the partner.

(1) A partner's basis is further decreased by the distributive share of the following partnership items:

(a) Partnership losses (including capital losses)

(b) Nondeductible partnership expenditures

(2) The basis of a partner's interest may not be decreased below zero.

(3) Losses and negative adjustments in excess of a partner's basis are accounted for as "limited losses." Such losses can offset future taxable income or can be claimed when basis is restored, for example, by a partner's contribution of money or property.

4542.02 The basis of contributed property is the same in the hands of the partnership as it was in the hands of the partner who contributed it.

a. As to the contribution of personal assets (nonbusiness property) to the partnership, however, the partnership basis will be the lesser of:

(1) the adjusted basis to the contributing partner or

(2) the fair market value at the time the property was contributed to the partnership.

b. Except for triggering recognition of limited losses, no gain or loss is recognized by either the partner or the partnership when a partner increases an investment through the contribution of property.

(1) Income must be recognized by a partner who receives a capital interest in the partnership in exchange for services rendered.

(2) The fair market value of the capital interest received shall be considered as compensation (ordinary income).

c. An increase in the basis for the fair market value of services contributed to a partnership by one of the partners is taxable to that partner.

d. A built-in gain or loss on the date of contribution must be allocated to the contributing partner when the property is subsequently disposed of by the partnership in a taxable transaction.

4542.03 Increases in the liabilities of the partnership are treated as though the partner contributed money for a share of those liabilities. The basis of the partner's investment increases accordingly.

a. Assumption by the partnership of a partner's personal liability is treated as a distribution of money to the partner. The partner's basis decreases by the amount of the liability assumed by the other partners.

b. Generally, the ratio for sharing *losses* is used in the calculation to determine a partner's share of the partnership liabilities.

4542.04 Partnership losses reduce the basis of the partner's investment in the partnership.

a. The TEFRA (Tax Equity and Fiscal Responsibility Act) system permits a partner to deduct the distributive share of partnership losses on the partner's return to the extent of the basis of the partner's interest in the partnership. A similar limitation will result under the BBA (Bipartisan Budget Act of 2015) system which will calculate partnership income and loss, and pay tax at the partnership level.

(1) For purposes of computing a partner's loss absorption ability, the basis of a partner's investment will not include any partnership liability for which the partner has no personal liability.

(2) This provision is designed to limit the loss that may be passed through to a *limited partner.* General partners are personally liable for the debts of the partnership, but limited partners are not liable beyond the amount of their contributed capital.

b. Any disallowed loss remains available to the partner in future years when the basis has increased so as to absorb some or all of the loss.

4542.05 The withdrawal of money or property from the partnership decreases the basis of the partner's investment by the partnership's adjusted basis in that property.

a. Generally, no gain or loss is recognized by either party when property is distributed in something other than the liquidation of a partner's interest. However, if a partner has contributed appreciated property to the partnership, the following rules may apply:

(1) If the appreciated property is distributed within seven years to another partner, the contributing partner must recognize the precontribution gain as income.

(2) If other property (other than cash) is distributed to the contributing partner within seven years, the contributing partner recognizes gain equal to the lesser of the precontribution gain or the excess of the distributed property's fair market value (FMV) over the partner's basis in the partnership.

b. The basis of the property received by the partner is the same as it was while in the partnership's possession.

c. When the partnership's adjusted basis for the property distributed exceeds the basis of a partner's investment in the partnership, the basis of the property to the partner is limited to the basis of the investment in the partnership.

(1) The basis of the partner's investment in the partnership is consequently reduced to zero.

(2) The partnership's excess property basis will be treated as a basis decrease to the partner.

(a) Distributions of unrealized receivables and inventory take the partnership's basis. Any shortfall is handled as described in (b) and (c) following.

(b) The basis decrease is first allocated to property with unrealized depreciation to the extent that basis exceeds FMV. If insufficient basis is available to reduce the partner's basis by the full amount of depreciation, available basis is allocated to the properties in proportion to their respective amounts of unrealized depreciation (Basis – FMV).

(c) Any remaining decrease is allocated to the properties in proportion to their adjusted bases.

4550 Limited Liability Companies

4550.01 Limited liability company (LLC)

a. An LLC is generally created under state law by filing articles of organization with the secretary of state's office. The articles must include such information as the following:

(1) The name of the LLC

(2) The duration of its existence

(3) The name and address of the LLC's registered agent (for such purposes as service of process)

b. The LLC's name must generally include the words "limited liability company" or similar words that indicate to third parties that the owners of the entity have limited liability.

c. Owners of the interests in an LLC are referred to as members. Most statutes require an LLC to have two or more members; however, some states do allow single-member LLCs. Generally, members of an LLC can be individuals, partnerships, corporations, or other LLCs.

d. An LLC is treated as a separate legal entity. Members have no personal liability for any of the LLC's debts simply by reason of being a member.

e. The members of an LLC have a right to manage that which is proportionate to their capital contributions. Members who actually engage in management owe fiduciary duties to the LLC.

f. If the actual authority of a member is not restricted, a member generally may have implied and apparent authority to bind the LLC on contracts entered in the ordinary course of the LLC's business.

g. State LLC statutes generally allow an LLC interest to be transferred as provided in the member's operating agreement.

h. If an LLC interest is transferred, the transferee generally has no right to become a member unless the other LLC members consent. A transferee who does not become a member is still entitled to receive either the return of their capital contribution or the fair market value of their LLC interest.

i. An LLC will generally dissolve upon the death, retirement, bankruptcy, or dissolution of a member. Liquidation of an LLC, however, can generally be avoided by unanimous consent of the remaining members to continue the LLC's business.

j. An LLC is treated as a partnership for federal income tax purposes unless an election is made on IRS Form 8832 to treat it as a corporation. A single-member LLC cannot be taxed as a partnership. A single-member LLC is mostly used by individuals to shield their personal assets from business liabilities. For income tax purposes, a single-member LLC is a sole proprietorship with the reporting of income or loss on Schedule C of IRS Form 1040, unless the single member elects to be treated as a corporation.

4560 Tax-Exempt Organizations

4560.01 **Types of organizations:** The Internal Revenue Code (IRC) includes rules that exempt specified nonprofit organizations from income taxation in most situations.

a. The organization must qualify as one of the specified classes of exempt organizations provided for in the IRC.

b. Examples of these organizations include charities, churches, educational institutions, social clubs, political organizations, employees' pension or profit-sharing trusts, certain cooperatives, and private foundations.

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